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# Governing England: Devolution and funding

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# Contents

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<b>Foreword</b>	2
Akash Paun	
<b>About Governing England</b>	3
<b>1. Funding England: a review of the issues</b>	4
Iain McLean	
<b>2. How England is funded</b>	11
Martin Rogers and Alun Evans	
<b>3. Equalisation, incentives and discretion in English local public service provision</b>	35
David Phillips	
<b>4. An exploration of the issues raised by the move towards to 100% Business Rate Retention</b>	53
Aileen Murphie	
<b>5. Funding combined authorities and city regions</b>	63
Tony Travers	
<b>About the authors</b>	72
<b>Acknowledgements</b>	73

By Akash Paun

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# Foreword

The British Academy's Governing England programme was established in 2016 to explore questions about England's governance, institutions and identity. One central focus of this work has been the English devolution agenda, looking at how successive governments have tried (occasionally successfully) to devolve power to England's cities, towns and regions.

During the course of the programme, the Academy has hosted a series of events across England, which have informed the production of two previous reports. The first, *Governing England: Devolution and mayors in England* (2017), examined the 'devolution deals' negotiated between central government and local authorities since 2015, leading to the election of 'metro mayors' in seven English city-regions.

The second, *Governing England: Devolution and public services* (2018), investigated the impact (actual and potential) of devolution in three important areas of public policy: health and social care, skills, and infrastructure.

A common theme emerging from this past work is that devolution cannot achieve its full potential as a mechanism for transforming the governance of England so long as the system for funding public services and local government remains unreformed and highly centralised. Furthermore, devolution is taking place in parallel with a sustained squeeze on local government budgets, making more urgent the question of how councils should be empowered to fund themselves.

In this context, the British Academy is pleased to be publishing this new report, *Governing England: Devolution and funding*. It comprises five excellent new papers which examine how government and public services across England are, have been, and should be funded from a range of perspectives.

In the Introduction, Iain McLean places current debates in a historical context and discusses why reform to local government funding arrangements has proven so contentious. He also asks whether now, finally, might be the time for radical change, for instance through some form of land value taxation.

Martin Rogers and Alun Evans bring together various data showing how England is funded within the UK and why this arrangement has been criticised. They set out that the majority of public spending in England is funded by revenue from central government, with smaller amounts from local government and the EU.

Next, David Phillips shows how the funding of local government is changing, including how the system is being reformed to place more emphasis on local fiscal incentives while reducing redistribution between richer and poorer areas. At the same time, he notes, healthcare and education funding are increasingly centralised.

Aileen Murphy delves into the issue of business rates retention, assessing the suitability of this reform as a method for funding local government. She discusses the main challenges, including the considerable variability in the financial position of local authorities and the fact that increased economic activity is not linked directly to business rate growth.

Finally, Tony Travers discusses how England's city regions have historically been funded, setting out that having been enacted under a highly centralised fiscal system, the recently created combined authorities and metro mayors have too few powers to transform the governance of England.

With the Government focused on Brexit above all else, there is a risk that the English devolution agenda is left in its current unfinished state. This publication should serve as a reminder that vital questions about the finance and funding of local government and public services remain unresolved, and it should help to facilitate a more informed public debate about how the system could be reformed.

**Akash Paun**

**Senior Fellow, Institute for Government, Expert Adviser to British Academy Governing England Programme, 2016-2018.**

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# About Governing England

Governing England is a multi-disciplinary programme which seeks to address a number of issues around the government and governance of England.

The project was conceived to address the place of England in academic literature at a time when Scotland, Wales and Northern Ireland received increased public and political attention, but the largest member of the Union did not. Since then the 2015 General Election and the 2016 vote to leave the European Union have brought the political preferences of those in England and those who identify as English into sharp relief.

The first year of the project investigated mayors and devolved governance arrangements. Our work in the first year engaged with representatives of the combined authorities, council leaders, academics, journalists, business and trades union representatives, MPs, Peers and civil servants. Roundtables exploring devolution arrangements were held as part of this series of work in Newcastle upon Tyne, Sheffield, Bristol, Winchester and Cambridge.

The second year of the project directly follows that initial work with a focus primarily on the funding of sub-national government in England and on public services. Many of those who attended the roundtables in the first year of the project were keen to move on to address how devolution would impact services.

The project is co-chaired by Professor Iain McLean FBA FRSE and Professor Michael Kenny. Members of the working group include Professor Sir John Curtice FBA FRSE FRSA, Rt Hon Professor John Denham, Professor Jim Gallagher FRSE, Guy Lodge, Akash Paun and Professor Meg Russell.

By Iain McLean

# 1 Funding England: a review of the issues

## WHY THIS PUBLICATION MATTERS

If you are reading this, you care about local government finance. It is a fact of life that most people don't. And yet they interact with local government all the time. Their council (or one of their councils) collects the most visible, and therefore one of the most hated taxes in the whole UK basket, namely Council Tax. Some council services affect everybody. Everybody knows that the council empties their bins. Therefore, people both wildly overestimate the proportion of local government expenditure that goes to this, and bitterly resent changes in the pattern of collection. Again, almost everybody knows that it is the local council which maintains local roads. As these roads have become more potholed, inconvenient, and even dangerous since 2005 (for reasons that are explained in the following chapters), so people feel more knocked about and angry.

The other universal service locally delivered is health. But the National Health Service has never been under local government control. There are local delivery bodies, which take big and momentous decisions with implications for people's lives. But those bodies are not elected, nor do they receive any local taxes. They are funded direct by central government. Whereas health is a big-ticket item, neither bins nor local roads are particularly expensive. The expensive local services, apart from health, are schools and social care. Everybody puts things in their bins and uses the local roads to access health care. But not everybody uses state schools or social care. These are services that you notice if your family uses them, and, if not, you may forget about them.

Another way to classify locally delivered services is to divide them into those whose cost rises faster than GDP and the rest. England has an ageing population. Most health and social care is consumed by the elderly. Therefore, for the foreseeable future, both health and adult social care costs will rise faster than general costs, and probably faster than tax receipts. While adult social care remains a service delivered by councils, this means that it is likely to push every other service – including bins and roads – to the back of the queue.

We are doing this work on the ways in which funds for public spending are raised and distributed in England because of two colliding factors. The amount of government money going to councils is being reduced and the demands on them are increasing. Something has to give. It is now all the more important to assess objectively how England is funded.

“The amount of government money going to councils is being reduced and the demands on them are increasing”

## INTER-REGIONAL EQUITY

A bit of autobiography may help explain my interest in this area. In 1973, at a tender age, I was elected to one of the brand-new metropolitan authorities described by Tony Travers in his chapter: Tyne & Wear County Council. Becoming vice-chair and then chair of its economic development committee, I was most involved in two policies. One was industrial regeneration in brownfield areas, of which there were many. The council had powers to improve these, but not enough. Against resistance from national civil servants, we fought for local powers, which we obtained in that splendid Victorian device, a local Act of Parliament (the Tyne & Wear Act 1976).

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The other burning issue was devolution. In Scotland, the Scottish National Party had just risen spectacularly, getting 30% of the vote in the October 1974 General Election. This did not reap it a commensurate number of seats, but it was enough to terrify the Labour government of the day, which depended on its seats in Scotland. It offered a Scottish assembly. Later, the offer was extended to Wales, but not to the regions of England. And yet, public expenditure statistics showed that although Scotland was richer than the Northern (now North-East) region of England, it received more public expenditure per head. To the extent that public expenditure relieves poverty, the North of England should have received more. Together with the leader and chief executive of Tyne & Wear Council, I helped to organise a conference to draw attention to this disparity. The *Scotsman* headlined us the *No-Men of England* (Ascherson 1977; McLean 2017).

As Tony Travers relates, Tyne & Wear, together with the other metropolitan councils, was ‘unceremoniously’ abolished in 1986. My next involvement with local government finance in England came from what was then called the Office of the Deputy Prime Minister (ODPM, now the Ministry of Housing, Communities, and Local Government). The ODPM and HM Treasury knew that the data for public expenditure per head for the English regions were poor. Because Scotland, Wales, and Northern Ireland had devolved governments and formal arrangements for grant transfers from the UK government, the data for public expenditure per head in these three territories have always been robust. There was no similar mechanism for the regions of England. The metropolitan counties had been abolished, although Greater London has returned with a mayor. There were nine standard regions of England, which are still used for statistical analysis. But the regions had few administrative bodies, and those that they had were abolished by the incoming Coalition government in 2010. It followed that there were no gatekeepers to ensure that English regional public expenditure met National Statistics quality standards.

To compile the regional public expenditure statistics, now known as ‘Country and Regional Analysis (CRA)’ and used by Martin Rogers and Alun Evans in their chapter, the Treasury had been sending a spreadsheet to each spending department, asking them to allocate expenditure in each of their programmes and sub-programmes to the nine English regions. But, with help from a public service mole, it took the research team no time at all to discover that many of the tens of thousands of data points in these spreadsheets actually contained no information at all. Some Departments simply took their England-wide expenditure on each programme and divided it among the nine regions according to their population proportions (which the Treasury had kindly supplied.) The ensuing ‘McLean report’ (McLean 2003; HM Treasury 2004) contained a number of recommendations for improving the CRA data. The Treasury adopted most of them and required departments to enter real data in their CRA returns.

One of the most difficult areas in which to get information was EU expenditure. The research team was unable to find any EU body with knowledge of, or even interest in, the regional distribution of EU funds spent in England. Unlike with CRA, reforming that system was not within the power of HM Treasury, but the British people have solved that problem for it by voting for Brexit. Rogers and Evans are able to give data on current EU spending per head in the four nations of the UK, and for the Social Fund they can give a regional distribution within England. For the considerably larger agricultural funds, no territorial data are available, but the relative agricultural intensity of each region makes it likely that East of England is the largest beneficiary per head.

Putting the improved CRA data together with an informed guess about the distribution of EU expenditure, the tables in Rogers and Evans’ chapter show that nothing much has changed since 1976. Scotland still has greater GDP per head than do either Wales or the northern regions of England, but, rather than receiving less public expenditure per head than these poorer regions, it received more. The other stark outlier is London. By far the richest region of the UK, it also benefits from considerably higher expenditure per head than most other regions. The chapters in this book explore why this might be.

The first equity crisis, therefore, relates to the anomalous position of Scotland in UK public expenditure. But there are also anomalies within England, which are at the heart of this book, and are discussed in the four chapters which follow.

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## EQUITY AND EQUALISATION

Rogers and Evans offer the relevant available data on the distribution of public expenditure around England, and list criticisms that have been made of the regime. Both David Phillips and Aileen Murphie explore aspects of this in more depth. The key themes are equity, equalisation, efficiency, and (tax) effort. Every local expenditure regime must have at least some regard to equity. In England, this is easiest to achieve in health spending, just because there are no locally elected bodies in the NHS (McLean 2005). Since the 1970s, the Department of Health and its predecessors have operated funding formulae which distribute NHS resources around England by reference to the morbidity, mortality, and health status of local populations. Where there are elected bodies, things are more complicated.

David Phillips explores the very rapid and little-noticed changes in English local government finance since 2005. Councils' responsibility for education has been removed. Their grant from central government, Rate Support Grant, has been substantially reduced and is due to be eliminated altogether by 2020. In 2015 the incoming government announced that the whole of local government services would move to funding only from Council Tax and business rates, the latter to be fully returned to local authorities by 2020 'at the end of the current parliament'.

Since then, some stuff has happened: notably the Brexit referendum and the 2017 General Election. The Chancellor who announced the relocalisation of business rates, George Osborne, has left politics. The Bill that would have formed the legal basis for relocalisation was dropped from the Queen's Speech in 2017. So English local finance is in a potentially dangerous limbo.

Both Phillips and Murphie discuss some first principles: Phillips about local finance as a whole, and Murphie about business rates specifically. Their chapters speak for themselves and must be read with care but contain some key themes.

The demand for equity comes partly from first principles and partly from fears of 'postcode lotteries'. The first principle, seen in universal support for the NHS, is rooted in the idea of a 'social union' (McLean, Gallagher and Lodge 2014). Belief in a social union entails belief that similarly situated citizens should be treated equally regardless of geography. Therefore, the lack of democratically-endorsed variation of NHS services in England can be justified.

But how far does people's belief in a social union go? This is an empirical question which has not been carefully tested as far as I know. People may be prepared to accept a postcode lottery in bin-emptying and pothole-filling (although even there not happily). But it is very reasonable to believe that people feel about schools and social care in a similar way to the NHS – that there should be national standards which each citizen should be entitled to expect regardless of geography, and in particular of whether they live in a council area with a robust or a weak tax base.

The case of adult social care is particularly acute. It has become local government's biggest expenditure line. Some standards are mandated by national legislation. As Phillips explains, '[T]he Care Act 2014 introduced new national regulations governing eligibility and assessment for publicly funded social care services. It also placed new statutory duties on councils to provide a number of specific services'. But equity in the delivery of adult social care requires robust equalisation. The need for state-funded social care is a function of the age structure, the morbidity, and the prevalence of deprivation in a council area. The need for social care in *general* is acute. But the need for *state-funded* social care is highest in those council areas where the lowest proportion of those needing care have their own or their family's resource to pay for it.

This raises a question that has troubled policymakers since the days of the Elizabethan Poor Law. Relieving poverty has always been seen as a local responsibility. But the areas with the most poverty are also the areas with the fewest resources to do anything about it. That was probably true in the days of Elizabethan almshouses. It is certainly true in the modern world.

Since the start of the welfare state in 1908-11, state pensions have always been funded in a way that reflects the social union: paid at a flat rate (with minor exceptions) to those who meet the criteria for them and funded out of general taxation. They therefore represent a net transfer from rich areas to poor ones, entirely outside any formal equalisation regime. Although sickness and unemployment benefit were nominally contributory from the start, the 1945-51 government, in vastly expanding their scope, also necessarily made them less contributory, and more linked to the social union. They too sit outside local government funding, as does the NHS.

This makes the situation with adult social care anomalous, especially as it is so intimately linked with NHS spending. To a large extent, NHS and social care expenditure on the frail elderly are substitutes – if not provided by one, it must be provided by the other; but adult social care, even 24 hours a day, is cheaper than treatment in an NHS hospital. The most comprehensive look at this problem – the Dilnot Commission – recommended a cap of £35,000 on individuals' liability to pay for their own social care; an increase in the means-tested threshold, above which people are liable for their full care costs, from £23,250 to £100,000; and that UK-wide eligibility criteria and portable assessments should be introduced (Dilnot 2011). This would have put social care funding on the same basis as NHS funding. The government of the day did not accept the Dilnot recommendations, but did not produce an alternative plan either, unless enacting a set of standards and leaving it to local authorities to pay for them be deemed a plan.

While Rate Support Grant provided the majority of local authority income it could be used as an equalisation device for both unequal resources and unequal needs. As to resources, Knowsley has a lower tax base per head than Kensington – whichever tax(es) form the base for local government income. Knowsley also has more needs, especially as spending is focused more and more on social care (children's as well as adults').

Local income taxes have not been seriously considered for England since the Layfield Report (Layfield 1976). As Travers explains, Layfield and colleagues asked government to face the choice: either give local government a serious tax base or make it an agent of central government. For forty years, governments have evaded Layfield's challenge. Local income tax would not solve the Knowsley/Kensington dilemma, but it does tax individuals on the basis of their ability to pay. Both of the taxes used to finance local government, Council Tax and business rates, fail even that test.

It is well known that Council Tax bands are coarse, are based on house prices in 1991, and lump all houses above a 1991 valuation of £320,000 into a single Band H. Hence it is regressive – it accounts for a higher proportion of the tax paid by poor people than by rich people. For the citizen, this is dampened by the Council Tax Reduction scheme, but from the authority's perspective this makes matters worse as the scheme is funded by authorities. But Council Tax is also *geographically* regressive. Poorer authorities – again, consider Knowsley – have many houses which in 1991 were worth £40,000 or less. Kensington has none. But the legislation anchors Council Tax rates to the amount chargeable on a Band D house, and the ratios between the bands are fixed in law. So, the Council Tax base in Knowsley is far smaller than in Kensington and there is nothing that the council can do about it. Accordingly, it must levy a higher rate on a Band D house. Some efficiency implications are considered below.

“ Since the start of the welfare state in 1908-11, state pensions have always been funded in a way that reflects the social union ”



Murphie asks whether business rates can form a suitable tax base for local government. As she observes, ‘business rates yield varies between areas through accidents of history and geography’. A chart in her chapter shows that in 2015-16, the gross yield of business rates per head varied from under £200 in the authority with the weakest to nearly £1400 in two upward outliers. The statistical ratio between business rates yield and social care need is precisely zero. Although the data points (councils) in the chart are not labelled, almost all the authorities with the most robust business rates tax base are in London: including Westminster, Kensington & Chelsea, Camden, Islington, and, notably, Hillingdon (Heathrow is within its boundaries). From the start of the present regime (after the collapse of the poll tax in 1991), the uneven base for business rates has not mattered because they were collected by each authority, pooled, and redistributed according to assessments of need. But, as both Phillips and Murphie explain, the needs assessment component of funding has been frozen and is due to disappear in 2020. As Murphie comments, ‘business rate income is not a solution and may well exacerbate differences between areas’. What redistribution mechanism will replace Rate Support Grant? None of us know.

## EFFICIENCY, AND EFFORT

Since the introduction of the Poll Tax, UK governments have been trying to design a local government finance system that encourages councils to be efficient, and to make appropriate tax effort. These two criteria overlap but are not identical. A council is efficient if it maximises outputs per unit input. It maximises tax effort if it grows its tax base. There are a number of potential ways to do that, but the most obvious is to grant planning permissions freely for new housing and commercial (re)development. But here local politics kicks in. Those who already live in the council area have votes. Those who might move in if new houses are built or new businesses attracted do not. So, there is a built-in bias against granting permissions.

Many of the policies introduced since 1990 have been addressed to these linked issues. The idea behind the ‘community charge’, the official name for the poll tax, was that councils would compete to show which was the most efficient. People would then move to authorities with low tax rates, as predicted by the Tiebout model (Tiebout 1956; Foster, Jackman and Perlman 1980). Each of the following three defects was alone sufficient to kill this idea:

- 1 Much of England has two tiers of local government. Almost nobody knows which tier of government delivers which service. Worse, the billing authorities are the lower tier, which outside the conurbations have few powers; they collect on behalf of shire counties which have all the expensive services.
- 2 As noted above, not all local government services are equally visible. Everybody notices the bins; nobody notices adult social care unless it affects a relative.
- 3 The tax base per head of authorities varies widely. When a council has low poll tax (now low Council Tax) charges, the elector does not know whether that is due to efficiency or a robust tax base.

The poll tax did not last long, but the three problems listed have done. One of them (two-tier government) would be easy to fix, at least outside metropolitan areas which are discussed next; but for the most part governments have not had the stomach for that fight.

To encourage councils to make tax effort and overcome ‘Nimby’ objections to planning applications, a policy of allowing (some) authorities to keep (some) of the extra business rates they raise has been in force for some years. This will be superseded by full relocalisation, if that ever happens. Councils have also been offered a direct bonus for new homes, although that was deducted from the rate support pool, so no new money was involved.

Thus, all the concepts discussed – equity, equalisation, efficiency, and effort – are important. But the UK government has not as yet found a way of reconciling them.

## POSSIBLE REFORMS: LAND VALUE CAPTURE?

Tony Travers' chapter opens by reflecting on how the railway created England's conurbations in the 19th century. This brought both economies and diseconomies of scale. The economies include opportunities for faster growth, because of more extensive division of labour. The diseconomies include congestion, land shortage, and transport problems. Some of these involve policy-making over a wider area than the traditional borough or city, let alone the small urban authorities that proliferated until local government reform in 1972. That was the rationale behind the creation of the Greater London Council in 1965 and the six metropolitan counties outside London in 1973. All seven were summarily abolished in 1986; but most of them have crept back. Four – London, West Midlands, Greater Manchester and Greater Liverpool, are back on the same boundaries as their ghostly precursors, or very nearly so.

Of these, the Mayor of London and the Greater London Authority have serious spending powers and serious authority over transport, fire, and policing. This does not apply to any of the others, even Great Manchester, which has gone furthest with some devolution of health funding. Unless the power to tax is joined with the power to spend, the new metro authorities may turn out to be damp squibs.

Urban authorities have a particular tax base that has not been sufficiently exploited in the UK. Land values increase, sometimes dramatically, when infrastructure improves. Studies done at the time of the Jubilee Line extension from central London to Stratford showed that property values rose all along the extension, and even along the original Jubilee Line up to Stanmore. But almost all that uplift has been a windfall for property owners. If a way were found to tax it, at any rate less than 100%, property owners would still get an uplift and the finances of conurbation local government would be transformed. Both Travers and Phillips discuss the pale substitutes (Community Infrastructure Levies, Section 106 Agreements), only to show how pale they are. City regions have recently been the most dynamic parts of the UK. Government policy has recognised this – for instance in the 'Northern Powerhouse' policies of the period 2010-16, in the proposals to relocalise business rates, and in the creation of metro mayor authorities. But all of these proposals lack an essential element. None of them tackles the inadequate tax base for local government. In cities, the problem is most acute, but the solution is closest to hand. Because infrastructure improvement is fastest in cities, so also is the uplift in land values. Governments have been trying since 1909 to capture this (Churchill 1909; McLean and Nou 2006) and mostly failing.

“ Urban authorities have a particular tax base that has not been sufficiently exploited in the UK ”

So, what may have changed? There is both a demand and a supply answer. The demand for a local tax base has become more acute with the withdrawal of rate support grant. On the supply side, the factor which has stymied all proposals for land taxes since 1909 is less acute, namely the difficulty of valuing land. But now, commercially available software can give you an estimate for the value of every house in the land at the click of a mouse. Most of the value of a house is the value of the land it sits on. With commercial properties, the market is less dense – there are fewer transactions per annum. Nevertheless, several studies have shown that calculating the uplift in land values created by planning permissions and infrastructure developments is feasible. Land value capture could revive local government in England more surely than any of the devices that have been tried since (and including) the Poll Tax.

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By Martin Rogers and Alun Evans

## 2

# How England is funded

## INTRODUCTION

Britain's impending departure from the European Union provides an opportunity to examine the way in which public expenditure in England is collected and distributed. Increased debate around public spending, promises of new investment for the NHS and local government facing unprecedented uncertainty in the way it is funded mean such an examination is all the more urgent. As political debate increasingly focuses on public finances and public spending this work sets out to inform that debate by, in Section One, detailing how public spending in England is raised and distributed and, in Section Two, setting out some prominent critiques of this arrangement.

Section One gives an overview of UK public expenditure, showing that England receives around 70% of all UK spending – £492 billion in 2016-17 or £8,898 per head of population. The main sources of revenue which fund this spending are central government, local government and the European Union. Section Two analyses critiques of the ways in which England is funded including criticism arising from differences in funding between England and Scotland and within England. Disparities in funding between the regions of England are also discussed, including transport spending, social care, and revenue generation.

“England receives around 70% of all UK spending”

Most taxation and expenditure within the UK is set and funded at the level of the UK government. Under this arrangement the UK government commits expenditure to those public services and benefits which are not devolved. Spending is thus not assigned to England as a whole, but rather to the public services which operate within England.

Around 95% of all public spending in England is raised by central government, mainly via income tax, National Insurance Contributions and Value Added Tax. Local government in England plays a small part in raising and distributing public spending in England. Of the approximately 5% of public spending attributed to local government the primary sources are central government (53%), Council Tax (29%), retained business rates (16%) with the remaining 2% from reserves and other sources. Finally, some money comes from the European Union while the United Kingdom remains a member, though the levels and destination of this spending is not consistent.

Overall, **England receives less public spending per head than the other nations of the UK.**

In some cases, this fact has caused resentment. Public spending also varies significantly within England.

# 1. UK public expenditure and how England is funded

The funding of England cannot be easily separated from that of the UK because spending is neither monitored nor controlled on a geographical basis (HM Treasury, 2017, p. 8) and because not all UK public spending can be geographically assigned. Around 88% of UK public spending is ‘identifiable expenditure’ such as health or education. The remainder is assigned to the UK as a whole, such as defence spending or debt interest (HM Treasury, 2017, p. 6). HM Treasury estimates that England received around 70% of identifiable UK public spending (Brien, 2017, p. 3), approximately £492 billion in 2016-17 (HM Treasury, 2017, p. 3).

Public expenditure in England is funded from three sources: central government, local government and the European Union. OECD data (Blöchliger & Nettle, 2015) indicates that around 95% of UK government spending is raised and distributed by central government, including money from the various funds associated with the European Union. The remaining 5% is raised and spent by local government (Blöchliger & Nettle, 2015). This balance is set to change, but England has no significant fiscal powers (Institute for Government, 2018). This arrangement makes England one of the most centralised developed nations (Blöchliger & Nettle, 2015) and organisations such as the International Monetary Fund have called for further decentralisation to allow greater responsiveness to the economic needs of areas within the UK (International Monetary Fund, 2018).

One justification for this high level of centralisation is that central government redistributes expenditure across the country. London and the South East of England are net contributors to the UK public finances while all other areas of the UK are net beneficiaries (The Office for National Statistics, 2017). A prominent role for central government allows it to redistribute revenues. Any reduction in the redistribution undertaken by central government therefore risks exacerbating the inequality within England (Amin-Smith, Phillips, & Simpson, 2018).

“One justification for this high level of centralisation is that central government redistributes expenditure across the country”

England receives less public funding per head than the other nations of the UK. HM Treasury figures (2017) show that in 2016/17 public spending per head was

- £9,159 in the UK as a whole,
- £8,898 in England (97% of the UK average),
- £10,651 in Scotland (116% of the UK average),
- £10,076 in Wales (110% of the UK average),
- £11,042 in Northern Ireland (121% of the UK average).

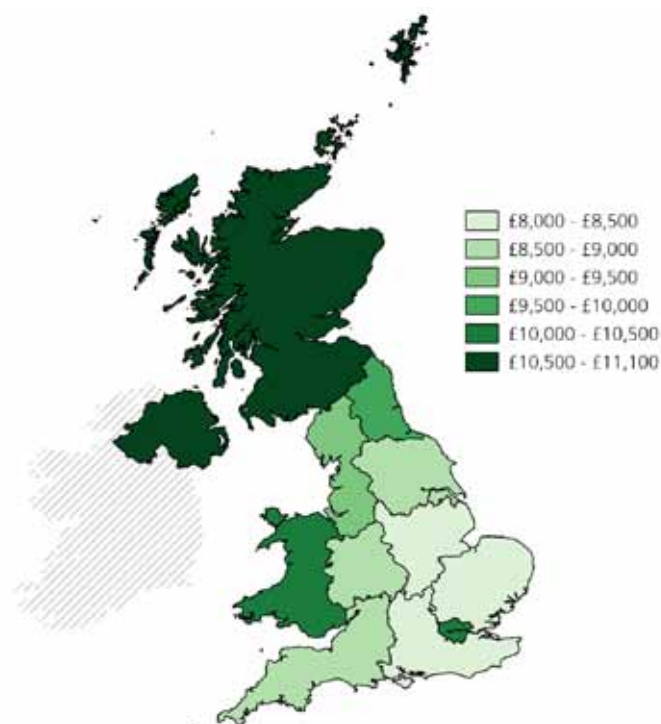
These figures are useful illustrations but must be treated with caution as they are estimates only. Additionally, figures are not directly comparable as certain items of expenditure are counted in some figures but in others - water, for example, is within the public sector in Scotland and Northern Ireland but not elsewhere (HM Treasury, 2017, p. 7).

**Public Spending per head by country and region, 2016/17**

	£ per head	Index: UK identifiable expenditure = 100
North East	9,680	106
North West	9,429	103
Yorkshire and the Humber	8,810	96
East Midlands	8,282	90
West Midlands	8,846	97
East	8,155	89
London	10,192	111
South East	8,111	89
South West	8,549	93
England	8,898	97
Scotland	10,651	116
Wales	10,076	110
Northern Ireland	11,042	121
<b>UK Identifiable expenditure</b>	<b>9,159</b>	<b>100</b>

Note: Includes only identifiable public spending on services

Source: HM Treasury, County and Regional Analysis 2017, 9 November 2017, Table A. 2  
(Keep & Brien, 2017, p. 5)

**Spending per head by country and region, 2016/17**

© EuroGeographics for the administrative boundaries  
Source: HM Treasury, County and regional analysis 2017, 9 November 2017

Public spending is not assigned geographically, but estimates can be made of where resources are spent. Within England, public spending per head is highest in London at £10,192 and the lowest in the South East at £8,111. The high rate of spending in London is often justified on the basis of the cost of providing services:

“The higher spend in London compared to other English regions is at least partly explained by the fact that for many functions it is more expensive to provide services in the capital, due to higher staff and infrastructure costs. In addition, London has historically high capital expenditure, including spend by Transport for London (TfL).” (HM Treasury, 2017, p. 4).

## CENTRAL GOVERNMENT

### Overview

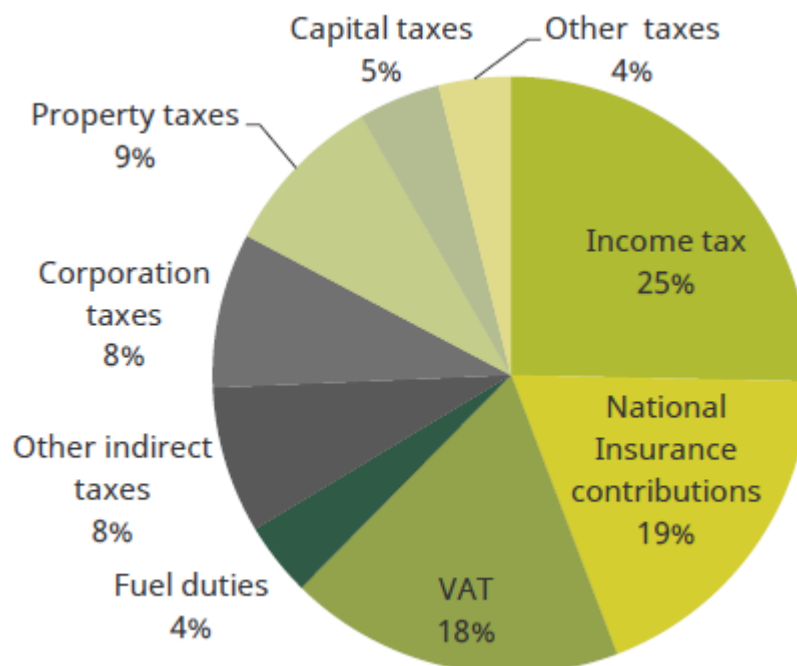
Most public expenditure in England is funded by central government. The UK government expected to spend just over £800 billion in 2017-18 (Brien, 2017, p. 3). Total receipts for 2017-18 were forecast to be around £690 billion (Miller & Roantree, 2017, p. 2). Of the £601 billion of public spending which can be geographically assigned within the UK, around £492 billion is assigned to England (HM Treasury, 2017, p. 3), roughly 82%. The population of England is around 84% of the population of the UK (The Office for National Statistics, 2017, p. 7) so England receives spending per head very slightly below a proportionate share of total UK spending.

“Most public expenditure in England is funded by central government”

### Central government revenue

The revenue which funds this expenditure comes primarily from three taxes which make up around 62% of tax receipts. In 2017-2018 these three were income tax, National Insurance Contributions and Value Added Tax (Miller & Roantree, 2017, p. 2). ‘Property taxes’ include Council Tax and business rates which contribute significantly to the funding of local government.

#### Composition of tax receipts, 2017-18



## Central government expenditure

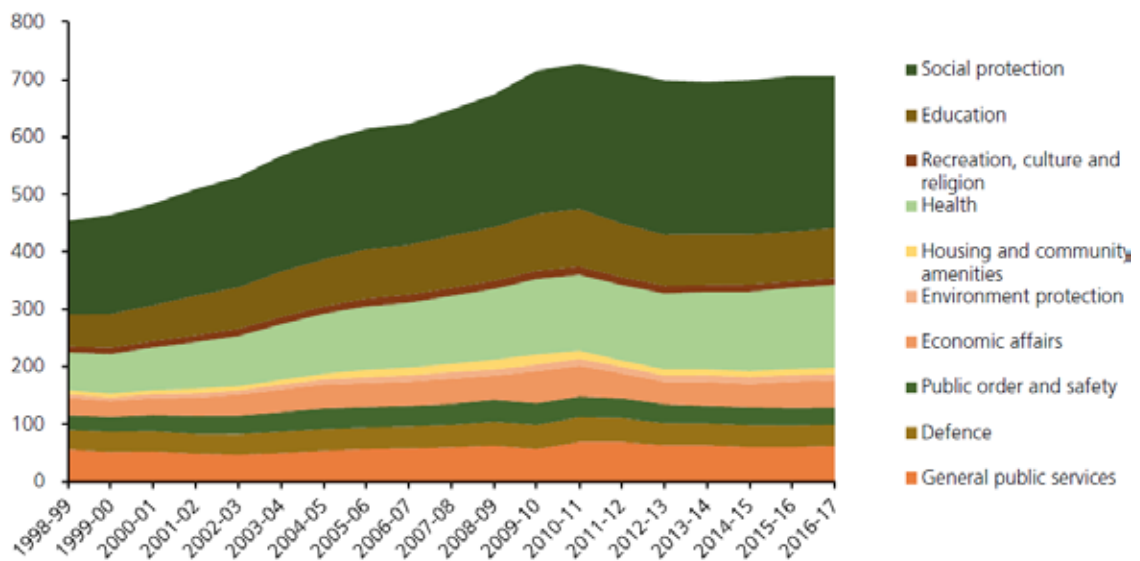
The central government departments which spend the most are the Department for Work and Pensions, the Department of Health and Social Care and the Department for Education. Together these three account for over half of planned expenditure for 2017-2018 (Brien, 2017, p. 3).

Public spending can be divided into six categories (Brien, 2017, p. 3):

- Planned spending such as the money assigned to be spent on a policy (Departmental Expenditure Limits),
- Spending that is responsive to demand such as benefits (Annual Managed Expenditure),
- Money spent on assets (capital spending),
- Money spent on day to day spending such as salaries (Resource Spending),
- Money spent on delivering the function of a department or body,
- Money spent on running a department or body itself.

The most significant expenditure is social security with pensions by far the largest (Brien, 2017, p. 10).

### Public spending by function, 1998-99 to 2016-17 £billions, 2016-17 prices



Note: Excludes EU transactions and accounting adjustments (Brien, 2017, p. 10)

## Borrowing and debt

The UK government borrowed around £40 billion in year April 2017 to March 2018 (Office for National Statistics, 2018). This 'public sector net borrowing' is often referred to as 'the deficit' and is the gap between total revenue and total spending. The UK government's total debt in April 2018 was around £1.8 trillion (Office for National Statistics, 2018). **The UK government is forecast to spend around £53.3 billion on debt interest in 2018-19** (Office for Budget Responsibility, 2018) which make debt interest the third largest item of 'day to day' spending behind the education budget (£62.4 billion) and around twice the size of the current second largest Annually Managed Expenditure item, currently personal tax credits (£26.0 billion).

“The UK government is forecast to spend around £53.3 billion on debt interest in 2018-19”



## DEVOLVED ADMINISTRATIONS

The UK government remains responsible for “UK fiscal policy, macroeconomic policy and funding allocation” (HM Treasury, 2015, p. 4) so most taxation within the UK is set centrally. After the devolution introduced to the UK in the late 1990s the devolved nations had the ability to spend money but not the responsibility for raising it. The limited steps towards fiscal devolution since then have been partly seen as increasing fiscal responsibility and accountability. The devolved nations of the UK are currently funded primarily from the central UK government (Keep, 2018, p. 3) though the composition of their funding is set to change with greater fiscal devolution (Institute for Government, 2018).

“The UK government remains responsible for “UK fiscal policy, macro economic policy and funding allocation””

### The Barnett formula

Spending in the devolved nations of the UK is often attributed to the Barnett formula, on which the differences in spending between England and Scotland are frequently, and incorrectly, blamed. The Barnett formula concerns only the change in block grant, rather than the absolute level: “when there is a change in funding for comparable services in England, the Barnett formula aims to give each country the same pounds-per-person change in funding” (Keep, 2018, p. 3).

When the UK government changes the funding allocated to a service in England that change is then applied to the comparable service in a devolved administration according to a ‘population proportion’. Thus, when funding for a service in England is changed, the devolved administrations automatically receive a change in their funding for comparable services. A simplified version of the formula is below:



(HM Treasury, 2015, p. 14)

Scotland has recently received greater control over taxation levels so the block grant from central government has been changed to reflect this, but the Barnett formula has not (Keep, 2018, p. 12). The change in the block grant was made to ensure that neither the UK central government nor the devolved administration were any worse off as a result of the changes.

## LOCAL GOVERNMENT

### Overview

Local government in England was due to spend £111 billion in 2017-18, excluding £20 billion on housing benefit (Department for Communities and Local Government, 2017, p. 4). This compares to over £800 billion spent by central government (Brien, 2017, p. 3).

Currently, **most local government revenue comes from central government (53%), with 29% from Council Tax, 16% from retained business rates and the remaining 2% from reserves and other sources** (Department for Communities and Local Government, 2017, p. 1). From 2010-11 to 2017-18 local authorities have seen a 49% reduction in their spending from central government which has led to a 28.6% real-terms reduction in the spending over which they have control (The National Audit Office, 2018, p. 7).

The control that local authorities have over their spending is described as follows:

“The role of the Secretary of State for Housing, Communities and Local Government is to set the overall framework for local government funding from central government. It is for authorities to make decisions on the allocation of their resources...Central funding and retained business rates are unringfenced and councils are responsible for the distribution and allocation of this resource across local priorities.” (Ministry of Housing, Communities and Local Government, 2018, p. 5)

Currently, half of the spending local authorities have control over is spent on social care which is a statutory obligation set by central government (The National Audit Office, 2018, p. 5).

“Half of the spending local authorities have control over is spent on social care”

### Local government revenue

The National Audit Office separates local government finance into three pillars: controllable income, non-controllable income and other income. Controllable income is that which local authorities have discretion over the spending and distribution of, while non-controllable income is passed through the local authority to bodies such as schools.

Controllable income was £58 billion in 2016-17. This consists of money from central government, Council Tax, and sales, fees and charges. Of this total £25 billion came from central government. This money is to be spent on delivering ‘statutory functions and duties’ (The National Audit Office, 2016, p. 4).

Business rates are pooled nationally and then redistributed to local authorities (Local Government Association, 2015, p. 1). These are thus counted within funding which comes from central government. However, the 2012 Local Government Finance Act allowed authorities to retain half of their business rates income with half given to central government for redistribution (Local Government Association, 2015, p. 1).

Councils also receive income from sales, fees and charges, which raised around £11 billion in 2014-15 (The National Audit Office, 2016, p. 4). An increase in utilisation of sales, fees and charges means that a greater proportion of the cost of a service is now usually paid by the user (The National Audit Office, 2018, p. 32). However, this money cannot be freely spent but must be netted off against the cost of the service for which fees are charged.

## Council Tax

Council Tax is the largest source of revenue for local authorities other than that received from central government. Council Tax first operated in April 1993, replacing the community charge or ‘poll tax’ (Sandford, Council Tax: FAQs, 2018, p. 5). Local authorities have freedom to spend the revenue from Council Tax as they see fit, it is not ringfenced but is pooled with other income for use by the local authority (Sandford, Council Tax: FAQs, 2018).

Council Tax is paid on residential properties in a banded system. The bands are based on sale values on 1st April 1991 (Sandford, Council Tax: FAQs, 2018, p. 5). Each band is in proportion to the others and at set values.

Range of values	Valuation band	Proportion of liability
Under £40,000	A	6/9
£40,001 – £52,000	B	7/9
£52,001 – £68,000	C	8/9
£68,001 – £88,000	D	9/9
£88,001 – £120,000	E	11/9
£120,001 – £160,000	F	13/9
£160,000 – £320,000	G	15/9
Over £320,000	H	18/9

(Sandford, Council Tax: FAQs, 2018, p. 27)

Comparisons in the levels of Council Tax in certain areas are made by comparing Band D Council Tax for a 2 adult dwelling to ensure like-for-like evaluations (Jackson L. , 2017). Using these figures, the region with the highest average Band D bills is the north east of England while the region with the lowest is London:

### Average band D Council Tax levels by English region 2017/18



(Jackson L. , 2017)

The authority with the highest average Band D rate is Weymouth and Portland Council with £1,891. The authority with the lowest average Band D rate is Wandsworth in London at £688, followed by Westminster at £700 (Jackson L., 2017). The figures of Council Tax per head are more varied and show the difference between tax rate and yield. Westminster gained £350 per head in 2016/17 while Wandsworth earned only £274, making it the authority with the second lowest Council Tax revenue per head after Newham (£253). The highest grossing authority per head was the City of London with £962, followed by Elmbridge with £786 (Local Government Association).

Non-controllable income totalled around £52 billion in 2016-17. This is money which is passed through local authorities over which they have little or no control and it is therefore not usually counted as local authority funding (The National Audit Office, 2016, p. 4). The largest portion, £30 billion, is passed directly to schools (The National Audit Office, 2016, p. 4). The remaining £20 billion goes to individuals on benefits, primarily Housing Benefit.

The final pillar is classed as ‘other income and revenue’ which consists of relatively small amounts, primarily income from investment activities.

### Changes to local authority funding

The way in which local government is funded is set to change. Recent years have seen moves to significantly reduce the amount of central government expenditure on local government.

The grant from central government (60% of councils’ non-school funding in 2009-10) is set to fall to zero in the future (Phillips, 2017) and be replaced by income from retained business rates (The Department for Communities and Local Government, 2017). The change to retained business rates is intended to incentivise areas to grow their tax base and to become less reliant on central government for their revenue (Amin-Smith, Phillips, & Simpson, 2018). This issue is discussed at greater depth elsewhere in this collection. Government plans to introduce 100% retention of the growth in business rates income have lost some momentum after not being included in the 2017 Queen’s Speech. However, several pilots are now taking place in England (The Department for Communities and Local Government, 2017).

“The grant from central government (60% of councils’ non-school funding in 2009-10) is set to fall to zero in the future”

While Council Tax rates in England were “largely frozen” between 2010 and 2015 (Miller & Roantree, 2017, p. 9), the cost pressure associated with cuts to budgets and growing demand for services, especially social care, has resulted in councils raising rates of Council Tax (The National Audit Office, 2018, p. 17). In December 2017 the UK government allowed councils with responsibility for social care to raise Council Tax by up to 3% in each band plus an additional 3% precept to fund social care without requiring a referendum (Sandford, Council Tax: local referendums, 2017, pp. 3, 10).

## THE EUROPEAN UNION

The UK government also receives some funding from the European Union while the UK remains a member. It is difficult to specify the exact amounts of EU funding spent in England as government estimates of expenditure financed by EU funds are made at the UK-level only (HM Treasury, 2017, p. 7). Additionally, figures are not constant or consistent so giving data for any single year would be misleading (Milne, 2016). The figures below are thus an approximation and use averages where possible.

Money from the EU comes primarily from two funds: the European Structural and Investment Funds and the European Agricultural Guarantee Fund.

<b>EU funding allocations to the UK, 2014-20 (€ billion)</b>	
<b>European Structural and Investment Funds</b>	<b>17.2</b>
European Regional Development Fund	5.8
European Social Fund	4.9
Youth Employment Initiative	0.2
European Maritime and Fisheries Fund	0.2
European Agricultural Fund for Rural Development	5.2
<b>European Agricultural Guarantee Fund</b>	<b>2.5</b>

(Ayres & Brien, 2018, p. 9)

The chart below shows the total EU budget allocations to go through UK public sector bodies, 2014 to 2020. This allocation amounted to around €41.5 billion. The European Regional Development Fund, the European Agricultural Fund for Rural Development and European Social Fund are European Structural and Investment Funds. The EAFRD is also part of the CAP. The figures throughout are chosen on the basis of availability and are not exhaustive.

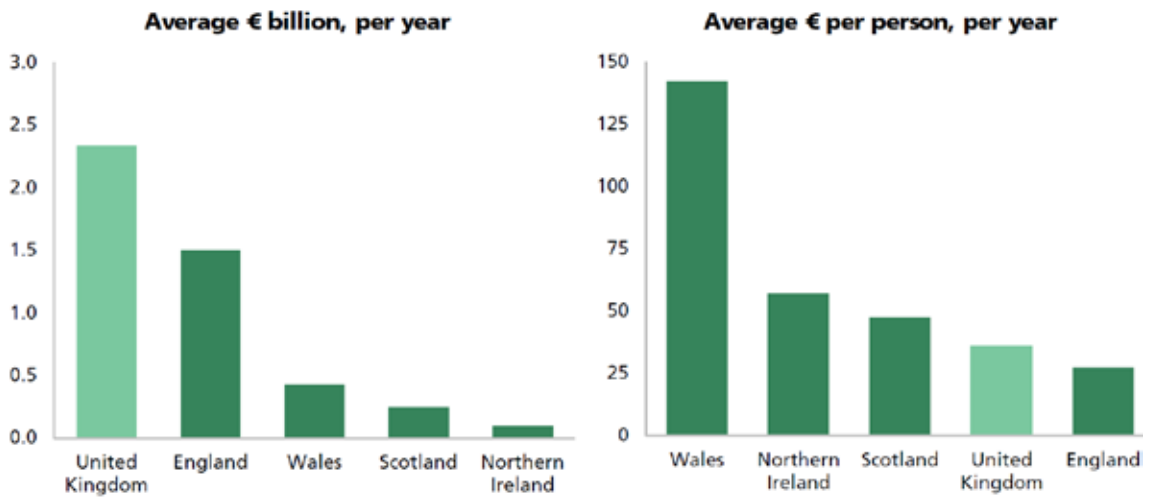
	<b>England £m</b>	<b>Scotland £m</b>	<b>Wales £m</b>	<b>Northern Ireland £m</b>
European Agricultural Guarantee Fund (EAGF)	16,421	4,096	2,245	2,299
European Regional Development Fund (ERDF)	3,628	477	1,407	308
European Agricultural Fund for Rural Development (EAFRD)	3,460	845	652	227
European Social Fund (ESF)	3,309	418	1,006	205
Youth Employment Initiative (YEI)	160	46	–	–
European Maritime and Fisheries Fund (EMFF)	97	108	15	24
<b>Regional totals</b>	<b>27,075</b>	<b>5,989</b>	<b>5,325</b>	<b>3,063</b>
<b>UK Total</b>	<b>41,463</b>			

(The National Audit Office, 2016, p. 17)

The National Audit Office has estimated that England was due to receive around €27.1 billion over the 2014-20 period which is an average of €3.9 billion per year from the EU to England via the UK's public sector (The National Audit Office, 2016). HM Treasury figures show that the UK was expected to receive around £4.4 billion in 2015 in public sector receipts (Milne, 2016).

The European Structural and Investment Funds are broken down by region. From this, England received around €10.6 billion during the 2014-20 period (Milne, 2016), an average of €1.5 billion per year.

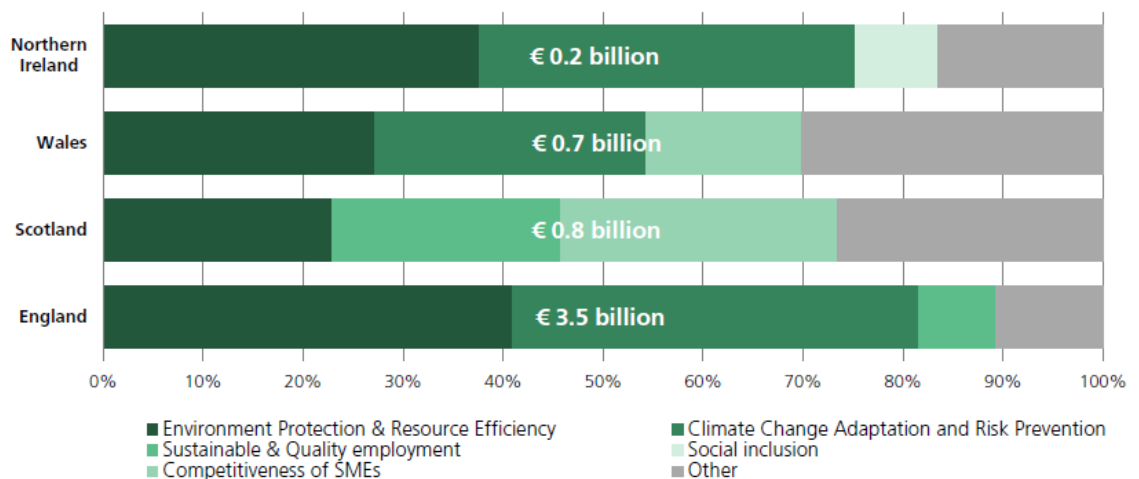
**Distribution of ESI funding across the UK, 2014-2020**



(Ayres & Brien, 2018, p. 13)

The single biggest source of EU funding to the UK is the Common Agricultural Policy (CAP). HM Treasury figures from 2015 indicate that 70% of the money the UK receives from the EU is under the CAP via the European Agricultural Guarantee Fund and the European Agricultural Fund for Rural Development (EAFRD) (Ayres & Brien, 2018, p. 16). This money from the CAP is delivered through the UK government. Figures from the Department for Environment, Food and Rural Affairs show that England received around €1.9 billion in 2015. The UK received €5.2 billion in from the European Agricultural Fund for Rural Development (EAFRD) in the 2014-20 period with England allocated 67% of this, which equates to €3.5 billion, around €0.5 billion per year (Ayres & Brien, 2018, p. 16).

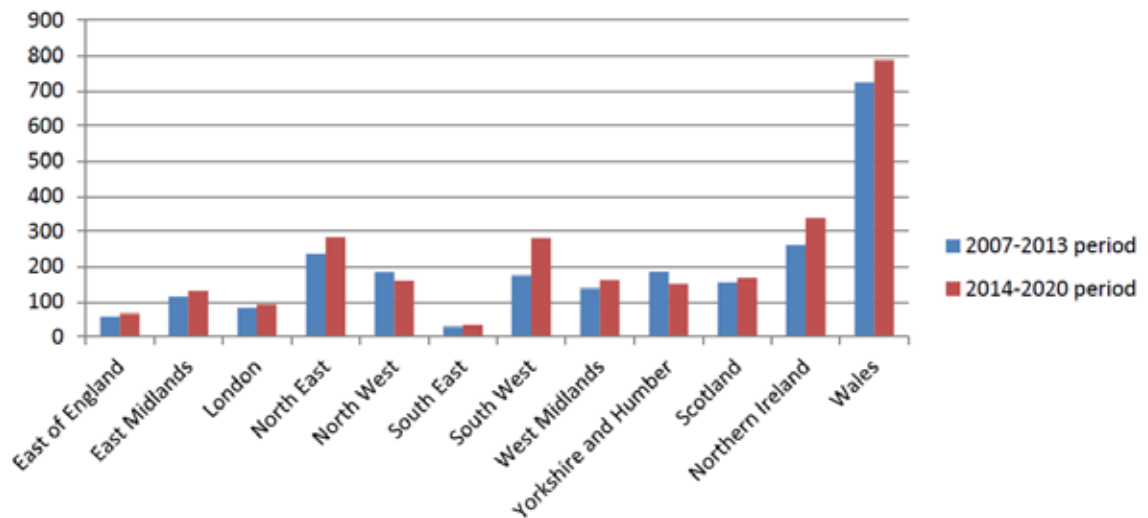
**EAFRD funding by country and largest sectors, 2014-20**



(Ayres & Brien, 2018, p. 16)

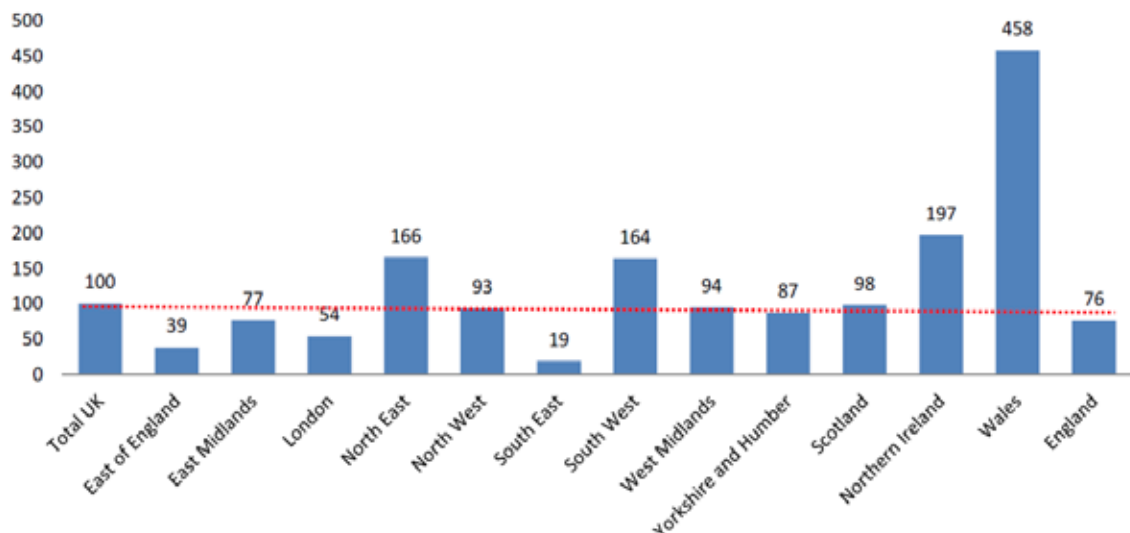
Analysis by the University of Sheffield (Hunt, Lavery, Vittery, & Berry, 2016, p. 3) estimated the distribution of funding from ERDF and ESF within England in 2014-20. The following graphs show the distribution of funds within England and the UK.

### Per capita combined ERDF and ESF allocations by region (euros)



(Hunt, Lavery, Vittery, & Berry, 2016, p. 4)

### Per capita ERDF and ESF allocations by region relative to UK average (UK = 100), 2014-2020 period



(Hunt, Lavery, Vittery, & Berry, 2016, p. 5)

Additional funds from the EU come directly from the European Commission, often after an application. The main sources in 2014-2020 are Horizon 2020, the Connecting Europe Facility and Erasmus+ (Ayres & Brien, 2018, p. 23).

Other European Union institutions which provide funding to the UK include the European Investment Bank and the European Investment Fund. The money from these is separate to the Multiannual Financial Framework. Data for recipients is not systematically collected at any level more detailed than the member state though data for individual projects is available.

Local government in the UK receives around £8.4 billion from the EU and the Local Government Association has called for the UK's government to replace this funding with the UK Shared Prosperity Fund (Local Government Association, 2017).

## 2. Critiques of the funding of England

The ways in which England is funded has attracted a number of critiques. This section draws several of these together, the main ones being the differences in spending levels in England and Scotland and the differences within England. This criticism arises in part because the distribution of funding does not take account of need, other than population change (Keep, 2018, p. 9).

The Social Mobility Commission highlight the “disparities in economic performance” in the UK and state that while “they cannot be corrected by central government alone...current patterns of public spending are, if anything, exacerbating the divide not healing it” (Social Mobility Commission., 2017, p. vi). The Commission points to education spending as “in 2016/2017 London spent about £1,000 more per pupil on local authority-maintained schools than the South East, the South West or the East Midlands, the three regions with the lowest attainment scores for disadvantaged pupils” (Social Mobility Commission., 2017, p. vi). It is important to look at the regional level but also below the region as “the North East, for example, overall currently receives a relatively generous level of funding for government services per head of population ...but it is heavily skewed towards welfare spending (taking almost half of the region’s total), while just 6 per cent goes to stimulating the regional economy through investment in science, employment and transport” (Social Mobility Commission., 2017, p. vii). The contrast with London is significant as “only one-third of London’s spending goes on welfare, with 12 per cent devoted to economic stimulation”.

**Firstly**, this section addresses the financial sustainability of local authorities due to their visible role in delivering services and concerns around ‘postcode lotteries’.

**Secondly**, the disparity between England and Scotland is discussed. This comparison has received negative attention from the public which has contributed to tensions around the place of England within the Union.

**Thirdly**, is the issue of disparities within England. The unequal distribution within England matters for several reasons, including social mobility and therefore efficiency.

**Fourthly**, several issues around the ways in which revenue is generated are discussed. As has been demonstrated taxation can shape economic activity and people’s lives, impacting on issues such as inequality (Office for National Statistics, 2018, p. 2)

“In 2016/2017 London spent about £1,000 more per pupil on local authority-maintained schools than the South East, the South West or the East Midlands”

### THE FINANCIAL SUSTAINABILITY OF LOCAL GOVERNMENT

UK governments since 2010 have sought to reduce spending on local government to attempt to improve the UK’s public finances. English local authorities have experienced an estimated 49% reduction to the funding which they receive from central government from 2010-11 to 2017-18 - this is controllable income (The National Audit Office, 2018, p. 7). This reduction is a real-terms reduction in local authorities’ spending power of 29% over the same period, a 3% real-terms reduction in spending for social care, and a 33% real-terms reduction in spending on non-social-care services. As a result of these reductions over 66% of councils with social care responsibilities drew on their reserves in 2016-17 (The National Audit Office, 2018, p. 7) and Northamptonshire County Council has encountered severe financial trouble and some believe it is highly likely that other councils will face similar financial problems (Fogg, 2018). Many councils fear for their future and the Local Government Information Unit reports that 80% of local authorities are concerned for their financial sustainability (Local Government Information Unit , 2018, p. 3). Further, there is uncertainty as to how local government will be funded after 2020 (Hodgson, 2018).



## THE DISPARITY BETWEEN ENGLAND AND SCOTLAND

One source of criticism concerns the difference in public spending between England and Scotland (Jeffery, Wyn Jones, Henderson, Scully, & Lodge, 2014, p. 11). Scotland has often been used to illustrate criticism of the distribution of UK public spending.

This is because some believe that Scotland appears to receive a 'subsidy' (Gilligan, 2011) from England to provide services which are not available in England, such as free-at-point-of-use prescriptions or university fees. The position of Scotland has attracted that criticism because of the differences on either side of the border with England as well as the fact that Scotland's per capita income compares favourably with much of England (Keep, 2018, p. 12).

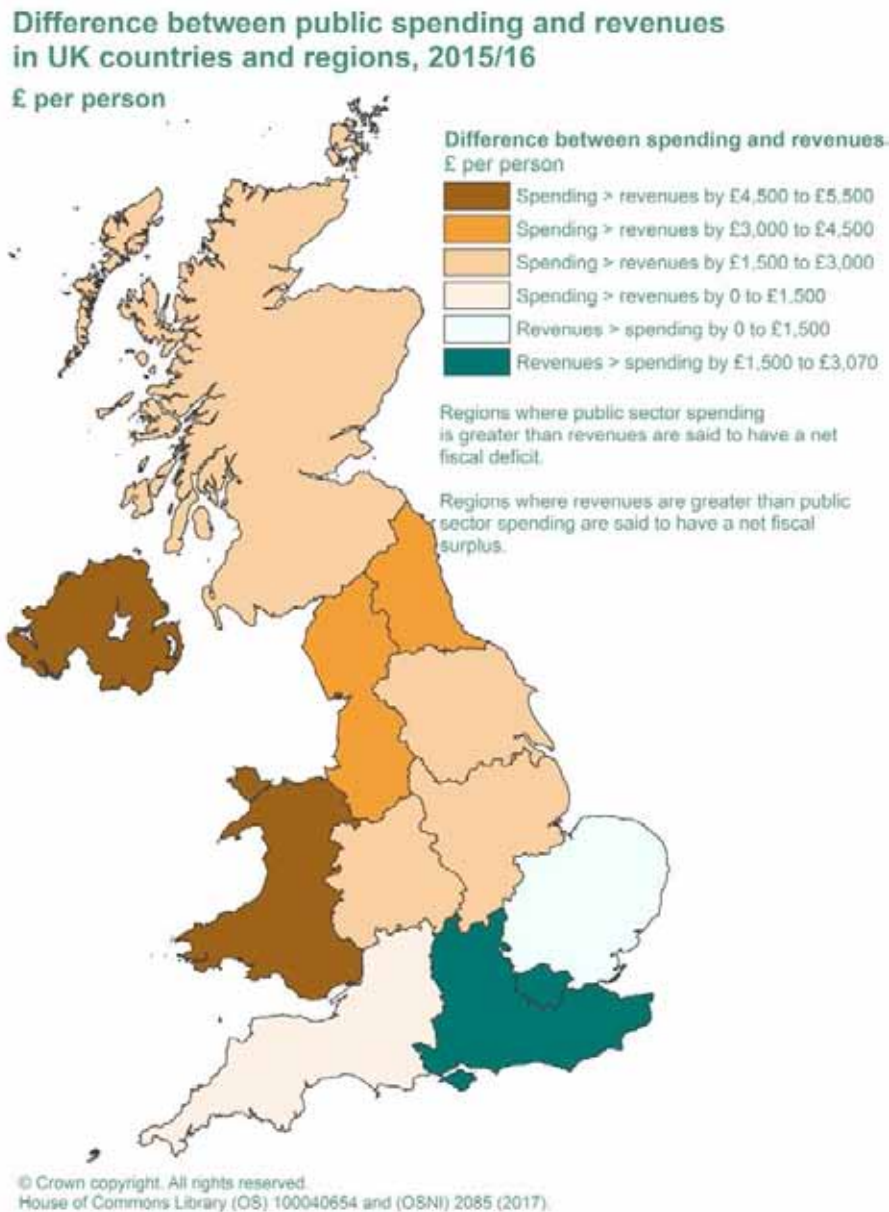
“Public spending in the North East of England is around £9,680 per head while in Scotland it is £10,651 per head”

The case of the North of England and the South of Scotland is illustrative as it shows the divergence between income and public spending. The average disposable income in the Scottish Borders is £19,257 per head, while for Northumberland it is £19,385 per head (The Office for National Statistics, 2017). Disposable income per person in Scotland as a whole in 2015 was £18,315 (Aiton, 2017), meaning that disposable income in the Borders is on average around £1,000 per head above the average for Scotland. However, public spending in the North East of England is around £9,680 per head while in Scotland it is £10,651 per head. Public spending per head in the UK is estimated to be £9,159, and £8,898 in England so the North East of England receives more than the average for England but less than Scotland.

## DISPARITIES WITHIN ENGLAND

As well as the differences between England and Scotland, there are significant differences within England. The varied levels of public spending in England are not determined by need and so more could potentially be done to bridge the gap between the richest and poorest parts of Britain which is the greatest of any EU country (The Economist, 2017).

The inequalities in spending in England are matched by differences in the generation of revenue. London and the South East of England acts as the primary source of taxation revenue for the UK government. This reliance may mean that the UK's finances are vulnerable if the ability of London and the South East to generate taxable revenue is adversely affected. In 2016-17 London received public spending of around £10,192 per head, the highest in England at 14% of the UK total (HM Treasury, 2017, p. 14).

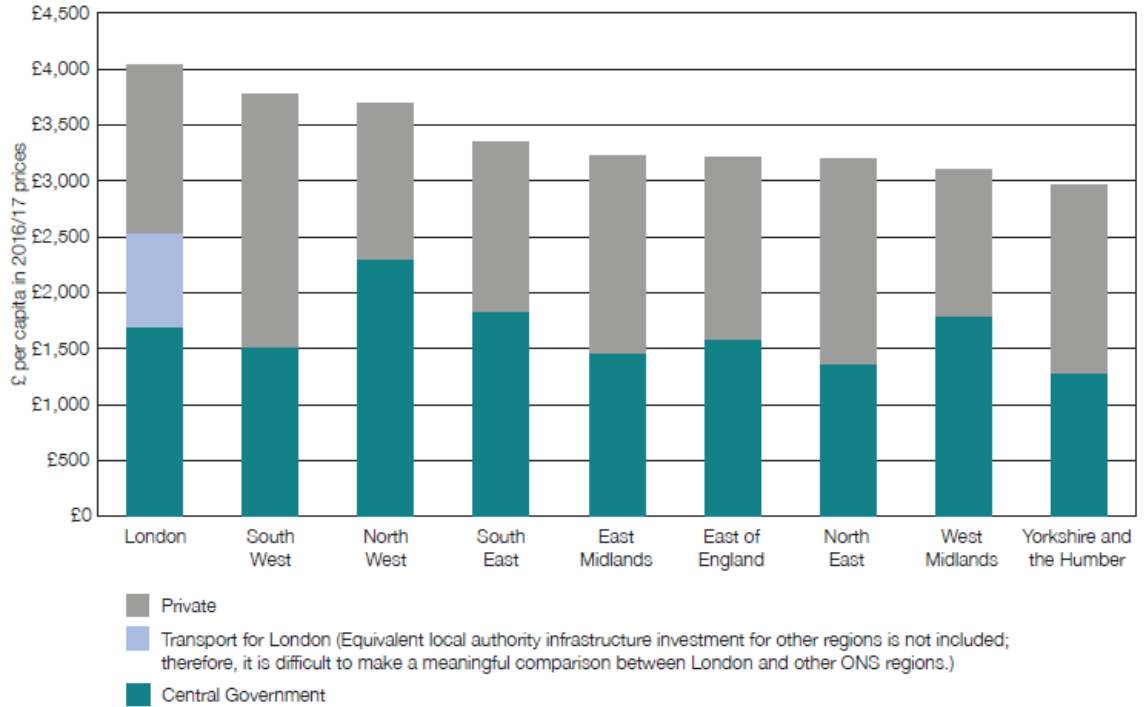


(Keep, 2017, p. 1)

## TRANSPORT SPENDING

The disparity in regional spending levels within England is exacerbated by transport spending, one area that can be clearly identified geographically. IPPR North figures show that transport spending of £4,155 per capita is planned for London, compared to £1,600 in the North as a whole (Raikes, 2018). According to the most recent data, of the £121 billion spent on transport in the UK between 2012/13 and 2016/17, 54% came from central government and 40% from local government (though in large part allocated by central government) (Raikes, 2018, p. 5). These figures are contested, however. On 27th February 2018 the Chancellor of the Exchequer cited Infrastructure and Projects Authority analysis which show a more even distribution through the UK (Hansard, 2018). Their analysis on the distribution of investment in the pipeline from 2017/18 to 2020/21 is shown below, but the Infrastructure and Projects Authority have warned that these figures are not exhaustive and may not give a full and exact picture (Infrastructure and Projects Authority, 2017).

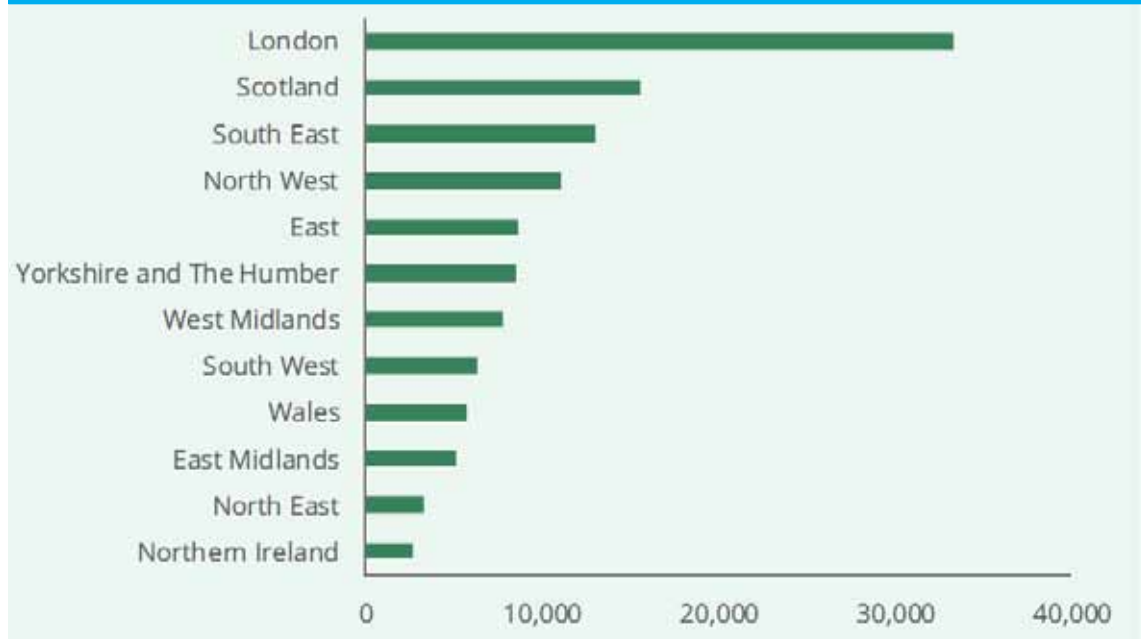
**Per Capita Regional Investment by Funding Source (2017/18 to 2020/21)**



(Infrastructure and Projects Authority, 2017, p. 19)

HM Treasury figures indicate that London received the most transport spending with £33 billion across the 2012/13-2016/17 period. The South East received the second most with £13 billion and the North East the least with £3 billion (Rutherford, 2018, p. 4). Using figures for a single year can be misleading as the figures can be skewed by projects which happen to fall within that year, such as Crossrail though figures for 2012/13 to 2016/17 show a clear trend.

**Overall public spending on transport by region, 2012/13 – 2016/17**  
£m, 2016/17 prices



(Rutherford, 2018, p. 5)

The OECD has called for greater spending on transport infrastructure outside of London and the South East (OECD, 2017, p. 5). However, the investment must be well directed in order to best utilise the benefits for productivity. Some have called for a change to the current strategy so that more investment is put in to commuter infrastructure rather than on focusing on projects which seek to increase the connectivity between cities (Elledge, 2017).

### Social care

The cost of providing social care accounts for around half of local authorities' controllable expenditure. Social care is partially funded and administered by local government, unlike the National Health Service which is financed from national taxation. Mooted moves towards health and social care integration (Bate, 2017) may require a change in the way that social care is funded. Trying to fund a national, statutory service from localised funding has resulted in a tension between national standards and local funding, especially as some of those areas with the greatest needs tend to be those with the least ability to pay (Phillips, 2017). Phillips explores this elsewhere in this volume. Devolution to Manchester is partly justified as a way to ensure that services are integrated so that service users experience less of a difference between the services though medical practitioners have warned that integration may not reduce costs (Rogers, 2018).

## REVENUE GENERATION

### Reliance on a small number of high rate payers

As well as a reliance on London and the South East for the net contributions to UK public finances, most taxation revenue is generated by a small number of individuals. Currently, the top 1% of earners contribute 27% of all income taxation revenue (Miller & Roantree, 2017, p. 3). This situation may mean that UK revenue is put at some risk if that income is threatened. Thus, moves to diversify the revenue base are likely to improve resilience and guard against future public finance crises.

### Business rates

Cuts to the funds that councils receive from central government mean that local authority funding has been reduced in recent years. At the same time, government looked set to move away from central government funding of local government and towards funding from the retention of business rates. The Local Government Finance Bill did not appear in the 2017 Queen's Speech but pilots have been undertaken which implies this policy is delayed rather than discarded (Murphie, 2018). Government has announced its intention to introduce at least 75 per cent business rates retention in 2020–21 (Housing, Communities and Local Government Committee, 2018). The business rates retention policy risks increasing financial divergence between areas, at least in the short term, if the redistributive function of central government is reduced (Amin-Smith, Phillips, & Simpson, 2018). As areas less able to raise revenues are often those with greater spending pressures, especially on social care, there is risk on both the cost and revenue sides and Murphie demonstrates in this volume that "need and business rate yield are not correlated". Further, retention of business rates incentivises councils relying on certain types of businesses, typically large out of town distribution centres. The other chapters in this volume discuss this issue at greater length.

“Government has announced its intention to introduce at least 75 per cent business rates retention in 2020–21”

## Wealth taxation

Most taxation in the UK comes from rates levied on income or consumption. This fails to reflect changing working patterns where income is increasingly taken in the form of dividends rather than salary and dividends which are taxed at a lower rate (Miller & Roantree, 2017, p. 12). Changing employment patterns are forecast to result in the loss of £3.5 billion of public revenue in 2021–22 (Miller & Roantree, 2017, p. 12). Further, the OECD has indicated that increasing wealth taxes are less likely to negatively impact growth than increasing income taxation, though “Britain raises more of its overall tax take from wealth taxes than any other OECD country” (The Economist, 2018).

The different rates at which income and wealth are taxed has incentivised the accumulation of wealth through property rather than work (Pickles, 2018) or investment and is unfair and inefficient (Glennerster, 2016). Property which is inaccessible to many has resulted in increased inequality (The Resolution Foundation, 2017) and may be deterring people from moving to areas such as London for work (Jackson G., 2018). The Confederation of British Industry’s most recent London Business Survey has described the availability of housing in London as a “ticking time bomb for firms”. Respondents reported concern that the availability of housing is negatively affecting recruitment of staff at all levels (CBI, 2018). Employers report that the availability of housing is leading to ‘premium salaries’, an inability to utilise flexible working, and employees leaving their jobs for those elsewhere.

## Council Tax

One current tax levied on assets rather than income is Council Tax. Council Tax is currently levied in eight bands, A-H, on property and is paid by the occupier according to the valuation of that property in 1991. Properties have not been revalued since the introduction of Council Tax in 1991. The Resolution Foundation (Corlett & Gardiner, 2018) and Martin Wolf (2018) have been among those who have called for some reform of Council Tax, for example by the addition of further bands as “any property worth more than £320,000 in 1991 is placed in the top band” (Wolf, 2018) which is now a relatively modest sum in places such as London. As a result, no more Council Tax is due on properties which are now worth a great deal more than when they were initially valued.

“Any property worth more than £320,000 in 1991 is placed in the top band”

The lack of revaluations means any change in effective demand for areas is not reflected in Council Tax banding. Areas of London such as Pimlico, Fulham or Peckham are now more sought after and expensive than when valuation occurred. Thus, those owning properties there receive a dividend from higher property values and market rents but relatively lower Council Tax. Indeed, as renters now outnumber owners in areas such as London (Morley, 2016) this has the effect that occupiers are taxed not according to their ability to pay but according to the worth of an asset owned by someone else. This effect is exacerbated by many of those occupiers being unable to buy a property.

Council Tax takes no account of the occupier’s ability to pay and is regressive (Corlett & Gardiner, 2018, p. 5). The owner of the property which sold for £16 million in 2017 would pay £250 more in Council Tax per year than the owner of a £18,500 property in County Durham (Copley, 2018). In London two three-bedroom flats illustrate the inequity of Council Tax. One such flat in Battersea, for sale for £2,100,000 has a Council Tax bill of £700 per year while a flat of the same size in Lambeth on sale for £400,000 has a bill of £1,160 per year (Corlett & Gardiner, 2018, p. 26). In neither case is the tax set according to the ability of the person(s) liable to pay.

Not only is Council Tax not reflective of the ability of the owner of that property to pay, but Council Tax may be the only tax paid according to someone else’s wealth with whom the payer of the tax may have no connection.

## Stamp duty

One other significant source of property-based revenue for the UK government is stamp duty. In 2016-17, £11.5 billion was raised from transactions in England, £0.3 billion from Wales and Northern Ireland. Within England, transactions in London contributed the most Stamp Duty Land Tax (SDLT) revenue at £4.5 billion (39% of total receipts), followed by the South East with £2.4 billion (21% of total receipts) meaning that London and the South East contribute around 60% of all stamp duty land tax (HM Revenue and Customs, 2017). In fact, the wide disparity in property prices between different parts of the country mean that “stamp duty revenues in Kensington & Chelsea have been higher than in Scotland, Wales and Northern Ireland combined” (Seely & Keep, 2018, p. 14). Scotland is not part of the UK stamp duty system since the Land and Buildings Transaction Tax replaced SDLT in Scotland from 1 April 2015 (Seely & Keep, 2018, p. 7). Wales received the devolution of SDLT in April 2018.

## CONCLUSION

Renewed political debate about the public finances, and ‘Brexit dividends’, highlight the need for an informed debate about how public spending is raised and distributed. Examining the public finances means acknowledging the position of England within the United Kingdom. The political preferences of the English have long been subsumed within the wider UK but an increasingly distinct political character, exemplified by support for Brexit, means England requires due attention.

Most public spending in England is funded by central government. The revenue which underpins this expenditure primarily comes from Income Tax, National Insurance Contributions and Value Added Tax. Much smaller amounts of revenue are raised by local government or funded by the European Union.

There are several critiques of the way that public expenditure is raised and distributed. England receives less public spending per head than the other nations of the UK, which has led to some resentment. There are also significant regional inequalities in public spending in England. Further, the way in which local government in England is funded has been criticised for being insufficient for the needs of local councils and for being unsustainable. One of the main ways in which local government can raise revenue for itself, Council Tax, has also been criticised for being dated and regressive.

Political choices are always careful balancing acts and every option has consequences which must be carefully analysed. One example is the move to fund local authorities by retained business rates income rather than central government grant. Such a change would risk increasing divergence between richer and poorer authorities by reducing the role of the state in redistributing revenue and may incentivise a certain type of economic growth which may not be suitable for wider economic development.

This work outlines concerns around the way in which public expenditure is raised and distributed in England. The richest region in the country, London, receives by far the greatest amount of public spending per head. This may have been fair and justified when London was marked by lower quality public services, especially schools, but London is now one of the most prosperous areas in the UK, albeit with a high cost of living and pockets of significant deprivation.

“The richest region in the country, London, receives by far the greatest amount of public spending per head”

The political uncertainty caused by Brexit, and the feelings of discontentment said to have motivated that vote, mean it is now ever more pressing to explore how England is funded. If many people feel that they are not listened to then they may feel that political outcomes are unfair (Rogers, 2016; Goodwin & Heath, 2016; Antonucci, Horvath, & Krouw, 2017). Given that those who identified as English were far more likely to have supported Leave in the Brexit referendum (Curtice, 2017), and those who identify as English are more likely to be concerned about the difference in funding between England and Scotland (Jeffery, Wyn Jones, Henderson, Scully, & Lodge, 2014) specific attention must be paid to these concerns. Brexit therefore provides an opportunity to debate what fairness means and how it can be manifested.

Brexit will mean that England may well lose some or all of the income which it receives as a member of the European Union. However, the UK is a net contributor to the EU budget so the government may gain a sum of money from this though the exact amount to be returned from the EU is controversial (Begg, 2018) and can only be spent once (Levell & Stoye, 2018). The terms of the UK's departure from the EU are yet to be decided but the country would benefit from an open and informed debate over how these funds will be distributed. The government has promised a UK Shared Prosperity Fund to replace EU funds and to seek to address inequality across the UK (Cornock, 2017) though the recent pledge of additional expenditure on the NHS has put the Shared Prosperity Fund at risk (Ahmed, 2018).

The financial pressures on the public finances, and the increasing demand for services, mean that ways must be found to put local government on a more sustainable financial footing to ensure that important services can be delivered. To that end Council Tax must be examined both in terms of the ways that local government is financed and how money is distributed. Given the greater reliance on Council Tax and business rates as sources of revenue for local government, this is an opportune moment to explore possible reforms of Council Tax including revaluation, the addition of new bands and the altering of the ratio. Council Tax is currently still based on the valuation of property in 1991, so all properties could be revalued to reflect their current worth. Given the uncertainty around local authority finance it is time to explore 'using the rest of the alphabet' in the banding of Council Tax. But in the longer term the suitability of Council Tax should be considered, and whether local services could be funded from revenue raised with greater account of the ability to pay. Concerns around the cost of living and the availability and affordability of property raise questions as to the suitability of Council Tax so debates around the public finances must be all encompassing.

One way in which reform could take effect would be to coalesce around the Northern Powerhouse. The Northern Powerhouse policy could bring about a very welcome rebalancing of the UK economy in order to lessen reliance on London

and the South East. Greater Manchester, as a key part of the Northern Powerhouse, has also started working towards the integration of services, especially across health and social care (Rogers, 2018) and the implementation of Public Health England's vision for place based health which will "blur institutional boundaries across a location to provide integrated care for individuals, families and communities" (Selbie & Kippin, 2016). One issue around moves to integrate health and social care is that health care is funded nationally but social care is funded locally. David Phillips has written on that subject in this volume.

Currently, England receives less public spending per head than the other nations of the UK which has caused resentment in some quarters, especially when comparing England to Scotland. The regions of England also receive divergent amounts of public spending. This may be the inevitable result of conscious policy choices such as investing in transport spending in and around London to utilise the economic power of the South East. However, the persistence of regional inequality in England suggests that more should be done to move towards a public expenditure system which is more responsive to need and addresses the imbalances within England and the current financial unsustainability in local government. The British Academy stands ready to contribute to that debate.

“ The government has promised a UK Shared Prosperity Fund to replace EU funds ”

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By David Phillips

# 3 Equalisation, incentives and discretion in English local public service provision

## INTRODUCTION

The financing of local public services involves a potential trade-off between the equalisation of funding between areas and the provision of fiscal incentives for economic growth. England's local government finance system has historically prioritised fiscal equalisation over fiscal incentives: central government grants were allocated to compensate for differences in local needs and tax bases. However, reforms and cuts to grants, and the introduction and planned extension of the business rates retention scheme are making councils' funding more dependent on local tax revenue performance. This has the effect of shifting the focus away from equalisation and towards incentives. In contrast, healthcare and, increasingly, education are funded centrally without reference to local tax revenue capacity.

This chapter describes the evolving system for funding local public services in England, with a focus on the role of equalisation, incentives, discretion and national service standards. It begins by setting out the pros and cons of local responsibility for public service spending and revenue-raising. It then describes the funding systems for key local services in England, paying particular attention to recent reforms to the local government finance system and changes to the funding of schools and adult social care services. The chapter concludes by outlining the broad choices available for future funding: (i) continuing with the current ad-hoc approach; (ii) the further centralisation of funding for adult social-care and potentially other services; (iii) increases in the general grant-funding for currently devolved services, and; (iv) the localisation of elements of health and schools funding. Each option has its pros and cons, but perhaps the most important thing is for funding policy to be consistent with broader policy objectives for different public services.

## I. BACKGROUND

In October 2015, building on reforms undertaken by the previous coalition government, then Chancellor George Osborne hailed a 'devolution revolution', with additional tax powers and spending responsibilities to be devolved to English local government (HM Treasury, 2015). While a cynic could see this as an attempt to offload a financial burden and risk on to local government, the pledge was welcomed by local government as an opportunity to tackle the perceived overly centralised nature of the English state. And it was sold by the Chancellor as an opportunity to empower and incentivise local areas to take more responsibility for local services and the promotion of local economic growth.

The reality is, of course, more complex. Government policy both before and after Mr Osborne's pledge has involved both a mix of devolution and centralisation. This reflects a tension between the provision of financial incentives for local government to boost growth and tackle spending needs, and the redistribution of resources to ensure people across England can access key services irrespective of local revenue-raising capacity and spending needs. There is also a tension between giving local government the discretion and autonomy to vary provision in response to differing local needs and preferences on the one hand, and a desire for common standards and access to services across the country, on the other. How these tensions are resolved matters: it may fundamentally change the relationship between local and national government, and between different parts of England.

As it stands, English local government is responsible for adult and children’s social services, public health, maintenance of local roads and provision of subsidies for local public transport, libraries, leisure centres, licensing and consumer protection, refuse collection and disposal, planning and housing. Fire and police services are also operated and part-funded at a local level, usually (and in the latter case always) via special-purpose authorities as opposed to general-purpose local authorities (generally termed ‘councils’).

Schools also traditionally fell under the remit of local government. However an increasing number are funded directly by central government as part of the Academies and Free School programmes. And health services are fully funded by central government, although operational decisions are taken at a local level by (unelected) local health bodies. Thus the two most costly and perhaps most politically salient areas of public service provision are ultimately the responsibility of central rather than local government.

To fund the services for which they are responsible, councils rely upon a mix of government grants and their own tax revenues: Council Tax, and since 2013–14, a proportion of business rates. For decades, general grant funding was allocated so as to compensate councils

both for differences in their local tax bases and in their spending needs (as assessed by central government).<sup>1</sup> This approach made it easier, at least in principle, to deliver a consistent standard of local public services across England, although councils could choose to set higher or lower Council Tax rates to fund higher or lower standards of service. The system insured councils against changes in their spending needs or tax bases that could otherwise significantly impact on their ability to provide services. However, it also significantly reduced financial incentives for councils to take action to boost local tax bases or tackle underlying drivers of spending need: cuts in grant funding would follow. Recent years have seen changes designed to strengthen financial incentives. 2013-14 was the last year for which grant allocations were updated on an annual basis to account for changes in local tax bases and assessed spending needs. It also saw the introduction of the business rates retention scheme (BRRS) which means councils bear up to 50% of the real-terms changes in local business rates revenues. Funding now increases or decreases when local tax bases change, and changes in assessed needs are no longer offset by changes to grants. And, in future the government plans to increase the share of real-terms changes in business rates revenues borne by local councils to 75% and perhaps even 100% (Ministry of Housing, Communities and Local Government, 2018). Indeed it is piloting 100% retention in large swathes of the country.

At the same time, central government has taken a more direct role in the allocation of funding to services traditionally within the purview of local government. Funding for schools was shifted from general purpose grants to ring-fenced grants from 2006-07 onwards, and as already mentioned, much of this now bypasses local government entirely to go directly to schools. The government also plans to eventually replace existing local formulae that determine funding allocations for different schools by a centrally-determined formula (Department for Education, 2017). National standards for assessments and minimum eligibility criteria (in practice used by nearly all councils) have also been introduced for adult social care. And an increasing amount of both grant funding and even Council Tax is ring-fenced specifically for adult social care.

This complex picture means it is therefore worth examining the factors that could affect the appropriate role for local and central government in funding and operating public services, and explore the options for the balance of responsibility between local and central government in the years ahead in England. This is the aim of this chapter.

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<sup>1</sup> Hendry (1998) charts the development of this system up to the mid 1990s. Gibson and Asthana (2011) describes and critiques subsequent changes to the system of tax base and spending equalisation

The rest of this chapter proceeds as follows. In Section II we review the literature on the trade-offs between local and national responsibility for determining spending on and raising revenues for public services. In Section III we describe and analyse the evolving system of funding local public services in England in more detail in light of this literature, paying particular attention to schools and adult social services. Finally Section IV concludes with a discussion of a number of options for the role of local and national government in funding public services in future

## 2. THE TRADE-OFFS BETWEEN LOCAL AND NATIONAL FUNDING RESPONSIBILITY

The responsibility for funding and delivering public services is split between national, state/ regional and local governments in all but the smallest micro-states. However, the extent to which responsibilities are devolved to sub-national governments varies significant between countries. For instance, OECD figures suggest that in 2016, the share of expenditure devolved to local government varied from around 7% in Greece and Ireland to over 50% in Sweden and 60% in Denmark (Table 1, column 1) (OECD, 2018a). On the revenue side, local taxes account for as little as 1% of overall revenues in countries such as Estonia and the Czech Republic, but as much as 36% in Sweden (Table 1, column 2) (OECD, 2018b).

### Expenditure and revenues devolved to local government (unitary states), 2016

	% of expenditure devolved	% of revenues devolved
Czech Republic	26%	1%
Denmark	63%	27%
Estonia	23%	1%
Finland	39%	23%
France	19%	14%
Greece	7%	2%
Hungary	13%	6%
Iceland	27%	26%
Ireland	8%	2%
Israel	13%	8%
Italy	27%	15%
Latvia	25%	19%
Luxembourg	11%	4%
Netherlands	32%	4%
Norway	33%	16%
Poland	31%	13%
Portugal	12%	7%
Slovak Republic	16%	2%
Slovenia	18%	10%
Sweden	50%	36%

Notes: Table reports results for unitary states only. In federal states, expenditures and revenues can be devolved to state as well as local governments. Figures for UK excluded as systems differ between constituent parts of the UK

Source: OECD (2018a, 2018b)

These differences will reflect a range of factors including geography (smaller countries are typically more centralised) and history (divisions of responsibility between national and sub-national governments tend to be long-lasting, especially where responsibilities are constitutionally defined). But they will also reflect different trade-offs being made between the benefits and costs of devolving operational, expenditure and revenue-raising responsibilities to local government.

## 2.1. The pros and cons of devolution

The literature highlights a range of practical and political-economy benefits from devolving revenue-raising and spending responsibilities:

- Local government may have greater knowledge about local needs and preferences, and a greater ability to tailor service offerings and levels of taxation and spending accordingly. Individuals and businesses then have the option of locating in jurisdictions whose tax/spend and policy mix most closely matches their preferences (Oates, 1972; Tiebout, 1956).
- Devolution can allow local jurisdictions to reap the financial rewards of higher revenues, lower spending needs, and more efficient service delivery. This can provide stronger incentives to boost local economies, tackle needs-drivers and improve efficiency both at a bureaucratic level and at a political level: local politicians can capitalise on higher quality services or lower tax rates / service charges or be punished for poor performance at the ballot box.<sup>2</sup>
- With policy being made in multiple jurisdictions, there can be opportunities for cross-jurisdictional learning both by policymakers and by voters. For instance, if voters can reliably compare policies and outcomes to those in other jurisdiction, this ‘yardstick’ can help them hold local politicians to account, incentivising better performance (Besley and Case, 1995).
- Some theoretical work also argues that devolution can overcome issues that can arise when decisions are taken centrally by politicians representing different geographical areas.<sup>3</sup>

However, these potential benefits are not a free lunch, and the literature also emphasises drawbacks from devolution:

- While some suggest that complex issues involving collaboration between multiple service areas and organisations can be better addressed at a local level (Cox et al, 2014), addressing other issues may be more difficult when multiple jurisdictions are involved. For instance, when infrastructure and services benefit residents of multiple jurisdictions, devolution may require costly coordination between jurisdictions and/or lead to under (or even no) provision of the item in question if such coordination is infeasible. It could also result in the loss of scale economies.
- Decisions by one local jurisdiction can impose damaging fiscal externalities on other jurisdictions.<sup>4</sup> For instance, when setting its tax rate, a jurisdiction may not account for the fact that rate cuts could cannibalise the tax bases and revenues of other jurisdictions. Tax competition could then mean that rates and revenues, and hence public service provision, may end up sub-optimally low. This may also reduce the scope for redistribution, as jurisdictions seek to boost tax revenues and reduce spending needs by enacting more regressive tax and spending policies than would be chosen by a centralised government.

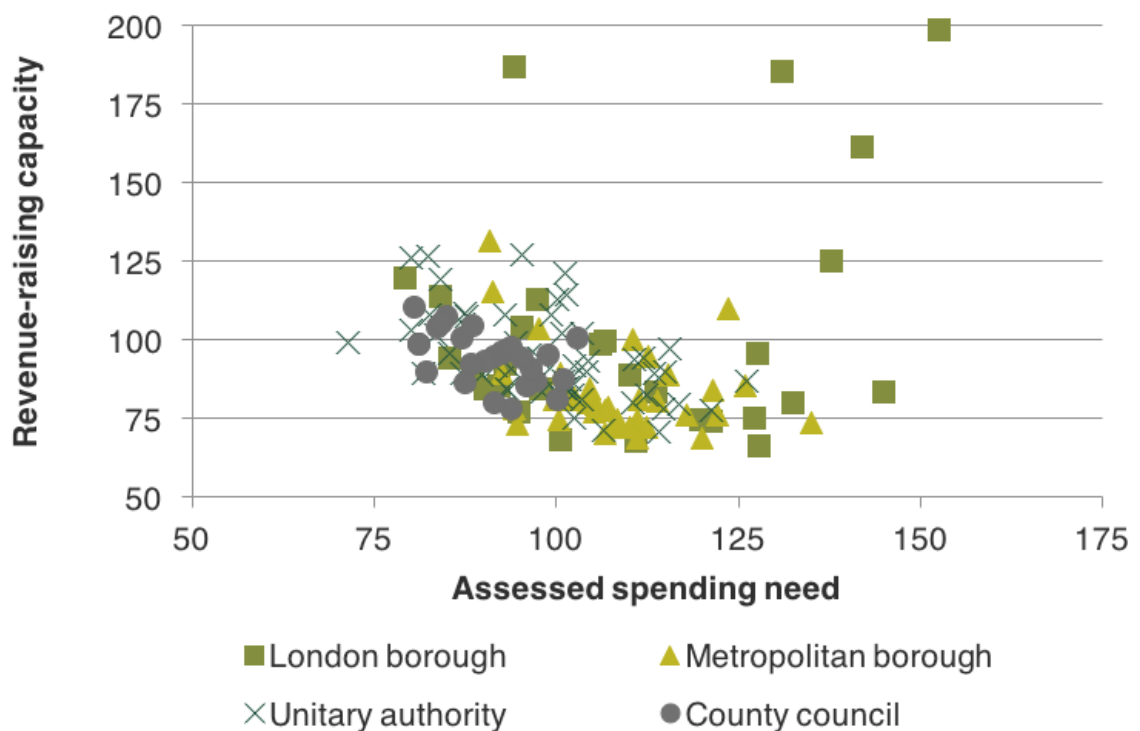
<sup>2</sup> Seabright (1996) and Persson and Tabellini (2000) highlight how devolution to local politicians makes decision-makers more dependent on pleasing voters in their particular jurisdiction, and hence more accountable across jurisdictions. Besley and Smart (2007) emphasise how this accountability to the local electorate has both a ‘disciplining’ effect on local politicians and a ‘selection’ effect, allowing higher quality / more honest decision-makers to be chosen. Hindriks and Lockwood (2009) study the operation of such effects under the assumption that local voters are not aware of policies and outcomes in other jurisdictions (ruling out so-called yardstick effects). They show that compared to centralised tax and spending decision-making, devolved decision making increases the strength of the disciplining effects of elections but increases the probability that in at least some jurisdictions, this disciplining effect fails to work at all.

<sup>3</sup> Lockwood (2002) suggests that devolution can reduce an over-focus on cost-minimisation when decisions are made centrally following bargaining between jurisdictions. In contrast, Besley and Coate (2003) highlight that when decision-making is centralised, voters have an incentive to elect representatives who favour high spending to obtain a larger share of overall expenditure, which can lead to overall expenditure being too high: devolution can avoid this excess expenditure.

<sup>4</sup> Brennan and Buchanan (1980) argue that this competition for mobile tax bases is a benefit of devolution that can limit what they see as a bureaucratic tendency towards large and inefficient government (the ‘leviathan’)

- More generally, devolution might be expected to contribute to inequality between citizens of different jurisdictions. The spending needs and revenue-raising capacity of different jurisdictions can differ due to differences in their geographical (e.g. terrain, climate) and socio-economic (e.g. the density, age-profile, health-status, and deprivation of local population) characteristics. Moreover, as illustrated in Figure 1 for areas of England outside London, one might expect a negative correlation between local revenue-raising capacity and spending needs per capita. Those areas with the greatest needs could be left with the least to spend.

**Council Tax and business rates revenue-raising capacity and assessed spending needs per capita by upper-tier council area in England, 2013–14 (mean = 100)**



Note: Excludes Camden, City of London, Isles of Scilly, Kensington and Chelsea and Westminster (for scaling purposes).

Source: See Figure 4.1. of Amin-Smith et al (2018b).

Fiscal equalisation can help address some of these concerns. Transfers from central government or between jurisdictions can redistribute between areas with high revenues to those with high needs. This can help prevent large divergences between revenues and spending needs from developing, and limits the gains from fiscal competition: growth in local tax bases, following tax cuts, for instance, can be offset by reductions in central government grants (or increases in the size of transfers to other jurisdictions).

However, such equalisation entails its own costs. As well as ameliorating potentially harmful incentives for inter-jurisdictional competition, it blunts incentives for more general efforts to boost revenue-raising capacity and tackle underlying spending needs. Jurisdictions can seek to game the equalisation regime if the indicators used for determining equalisation flows can be manipulated or relatively easily influenced. Equalisation regimes can also become complex and be prone to rent seeking as different jurisdictions seek to influence the formulae and factors used to their own advantage.



## 2.2. Empirical evidence on the effects of devolution

The key benefits of devolution are therefore: an increased scope for policy to reflect local needs and preferences; greater political accountability to voters; and stronger fiscal incentives. The drawbacks are related to spillovers – including fiscal externalities – between jurisdictions; the potential to exacerbate geographical inequalities; a reduced ability to redistribute both geographically and interpersonally; and a loss of economies of scale and scope.

There is therefore no clear-cut answer as to whether (more or less) devolution is a good thing: different people may trade-off the issues (e.g. incentives versus redistribution) in different ways; and both preferences and trade-offs may differ for different services (e.g. leisure and cultural facilities versus schools and hospitals). Empirical analysis can also help inform us about the nature of these trade-offs: so what is the empirical evidence on the impact of devolution?

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A wide range of studies investigate the impact of devolution on a range of outcomes including: health,<sup>5</sup> education,<sup>6</sup> the efficiency of public services,<sup>7</sup> geographical and inter-personal inequalities,<sup>8</sup> and overall economic performance.<sup>9</sup> The cross-country studies generally find that devolution is associated with improved public services and higher levels of and faster growth in gross domestic product (GDP) per capita. The latter finding is stronger for revenue devolution than expenditure devolution, although some studies suggest that there are benefits of ensuring ‘balanced’ devolution, as a reliance on transfers between central and local governments is sometimes associated with poorer performance.

Evidence on the impact of devolution on inequality is more mixed. Cross-country studies suggest that greater expenditure and especially revenue devolution are associated with lower geographical inequalities in economic output but could increase inequalities in household incomes and public service provision. There is no consensus on the impact of devolution on inter-personal inequalities. Some studies suggest revenue devolution is associated with higher inequality (Sacchi and Salotti, 2013), while others suggest impacts differ according to which part of the income distribution one considers (Sibylle and Blochliger, 2017).

In deciding how much weight to place on these findings, it is important to note the difficulties with inferring causal impacts from cross-country correlations. Many of the findings turn on the inclusion of Scandinavian countries – which are rich, equal, and have good public services and high degrees of both expenditure and revenue devolution – in the analyses. The strength of the evidence in favour of devolution is therefore probably less than the broad consensus in the literature would, at first glance, suggest.

It is also worth bearing in mind that significant devolution can be accompanied by a high degree of fiscal equalisation, and most studies do not control directly for equalisation arrangements. Indeed, there is relatively little evidence on the effects of fiscal equalisation on public service and economic outcomes.<sup>10</sup> Fiscal equalisation is shown to reduce disparities between jurisdictions’ revenue-raising capacities, even in highly decentralised countries like Finland and Sweden (Blochliger et al (2007)). But arrangements are shown to be prone to both gaming by local jurisdictions and distortions due to political considerations.<sup>11</sup>

Overall then, while there is suggestive evidence that expenditure and revenue devolution is associated with improved public service delivery and stronger economic performance, the evidence is not that strong. Impacts on geographical and inter-personal inequalities seem to be complex, and fiscal equalisation is shown to be important in reducing disparities in jurisdictions’ revenue-raising capacities – and hence in the services they can offer to citizens.

5 Cantarero and Pascual (2006) and Cantarero and Pascual (2008) provide analysis for the EU and literature reviews.

6 Fredriksen (2013) and Blochliger (2013) are typical examples. 8 See Sacchi and Salotti (2013), Cavusoglu and Dincer (2015), Bartolini et al (2016), Blochliger et al (2016) and Sibylle and Blochliger (2017).

9 Blochliger and Egert (2013) is a typical example.

10 A number of studies examine impacts of fiscal equalisation on revenues and tax rates including Baretta et al (2002), Buttner (2006) and Smart (2007).

11 See for instance Johansson (2003) for a Swedish example and Hilber et al (2011) for an English example.

### 3. THE FUNDING OF LOCAL PUBLIC SERVICES IN ENGLAND

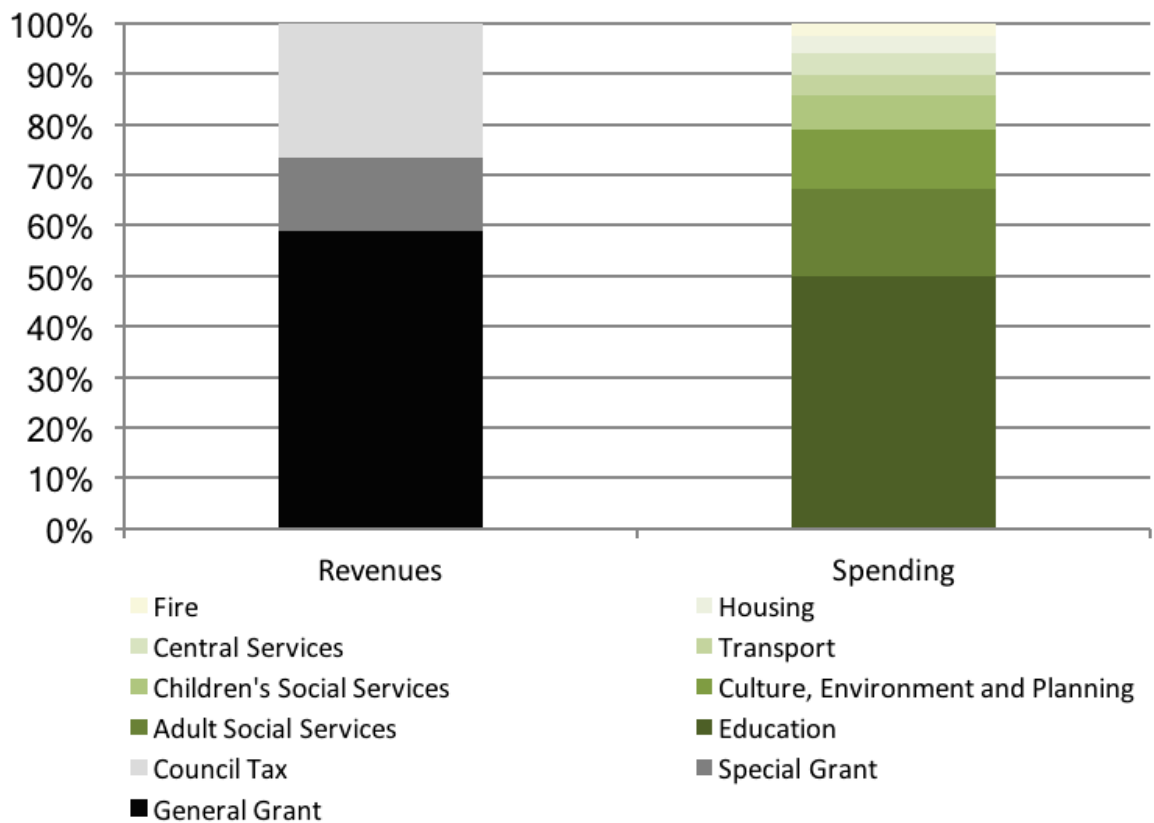
We now describe the changing system of funding local public services in England in light of the discussion in Section II. The local government finance system that pertained between the 1990s and mid 2000s can be thought of as combining a moderate degree of expenditure devolution, with a limited degree of revenue devolution, and a high degree of fiscal equalisation. In 2005–06, 59% of councils' net revenue expenditure was financed by general grants from central government, 14% by specific or ring-fenced grants, and 27% by Council Tax revenues.<sup>12</sup>

#### 3.1. The funding system for local services in 2005–06

In that year, councils had responsibility for funding and organising the delivery of key local services including:

- Education services for children aged up to 16;
- Children's and adults' social care services;
- Housing and services for the homeless;
- Maintenance of local roads and support for local public transport;
- Libraries, leisure centres, and parks;
- Refuse collection and disposal;
- Local environmental regulation and licensing;
- And planning and local economic development.

#### Local government revenues and spending, 2005–06



Source: Author's calculations using CIPFA (2006).

<sup>12</sup> Author's calculations using CIPFA (2006). Figures are for London boroughs, metropolitan and non-metropolitan districts, unitary authorities, counties, single purpose fire authorities and transit authorities only (i.e. police authorities and the Greater London authority are excluded).

Councils had discretion over how to allocate their Council Tax, general grant and indeed a significant part of the specific grant funding across services, subject to meeting statutory requirements for the availability and quality of key services. This discretion extended to key services like adult social care. In addition to Council Tax and general grant funding, councils received a range of specific grants for social care (£2.4 billion), but only a minority (£835 million) was specifically ring-fenced for these services (Department for Communities and Local Government, 2006). Under the 'Fair Access to Care Services' policy, councils also had a significant degree of discretion in determining service offerings, care needs assessments and eligibility criteria (Department for Health, 2003). For instance, eligibility criteria were based on four bands of assessed risks to individuals in the absence of care (low, moderate, substantial and critical), with different councils choosing different thresholds.<sup>13</sup>

The majority of funding for schools came from Council Tax and general grant funding, which councils notionally had discretion over: in principle, they could spend more or less than central government's assessment of their school spending needs, and they chose their own formulae to allocate funding to individual schools.<sup>14</sup> However from the early 2000s councils were strongly encouraged (and in some instances mandated)

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to pass on increases in central government's assessments of their school spending needs. This meant councils' discretion to spend less than what central government assessed them to need to spend was being progressively limited. Councils' discretion on the revenue side was also subject to significant restrictions. A system of locally varying business rates was replaced by a national system in 1990–91, the revenues from which were collected by councils but then pooled and allocated as part of general grant funding.

Councils' discretion on the revenue side was also subject to significant restrictions. A system of locally varying business rates was replaced by a national system in 1990–91, the revenues from which were collected by councils but then pooled and allocated as part of general grant funding. Councils had discretion over the headline rate of Council Tax, but following very large increases in previous years (particularly 2003–04), the government utilised the power to cap Council Tax increases (via capping overall budgets) for nine local authorities.<sup>15</sup>

The limited degree of revenue devolution was accompanied by a high degree of fiscal equalisation, taking into account both revenue-raising potential and assessed spending needs. In particular, grants were allocated in order to equalise the needs-adjusted spending power of different councils.<sup>16</sup> This also provided insurance: if the assessed relative spending need of a council increased, or its tax base decreased, it would be compensated in the form of higher general grant-funding. But the flip side of this was a lack of incentives for improving socio-economic conditions: reductions in assessed needs and increases in local tax bases were offset by reductions in grant funding.

The system for funding health services exhibited a similar high degree of fiscal equalisation: funding was entirely from central government and was allocated to areas according to needs-based formulas.<sup>17</sup> However, it is important to note that while the total level of spending on health in different parts of England was determined centrally, the NHS was not a single national organisation. Decisions on how to allocate spending within areas was largely devolved to local NHS bodies: Primary Care Trusts (on the commissioning side) and various hospital and other trusts (on the provider side). Unlike councils, the executive of these bodies was not political, and so was not directly accountable to local residents. Instead, accountability was via a range of centrally-imposed targets, and via the commissioner-provider split (designed to promote competition and efficiency).

13 53% used a threshold of 'substantial' or 'critical', and 47% a threshold of 'low' or 'moderate' (Commission for Social Care Inspection, 2008).

14 Central government did place restrictions on the weights to be given to particular indicators in these formulae though. See Belfield and Sibieta (2016).

15 House of Commons Library (2004) describes the capping regime. For information on capped councils, see [https://publications.parliament.uk/pa/cm200506/cmhansrd/vo050707/wmstext/50707m01.htm#50707m01.html\\_spm2](https://publications.parliament.uk/pa/cm200506/cmhansrd/vo050707/wmstext/50707m01.htm#50707m01.html_spm2).

16 Each council was assigned a Formula Spending Share, which was its estimated share of the national need for spending (by service area) calculated using historic relationships between local characteristics (such as demographic structure, deprivation, health, labour and property costs) and councils' spending. These shares were then multiplied by the total in grant funding and Council Tax available at a national level, to obtain a cash-terms spending need. The amount each council could raise if they set their Council Tax rates at the same notional level was then subtracted from this spending need to obtain the amount of general grant funding for each council (subject to 'damping' to prevent excessively large changes year-to-year and to guarantee grants increased by an agreed minimum percentage). Gibson and Asthana (2011) provides further detail.

17 As with the local government formula though, damping arrangements (termed 'pace of change' adjustments in the NHS) were in place to prevent excessively large changes in funding from year-to-year. See Wood and Heath (2014).

### 3.2. Changes to the system for funding local services 2005–06 to 2020–21

The policy narrative of recent years has been one of localism and decentralisation. One might therefore expect the policy reality to be one of significant devolution of spending and revenue-raising responsibilities and powers. However, the picture has been more complex, with both devolution and centralisation taking place. The most notable change is the shift in focus from redistribution towards fiscal incentives in the local government funding system.

#### Transfers of responsibility and devolution deals

There are a number of areas where local discretion has been increased, or expenditure responsibilities (and associated funding) have been transferred to councils and other local bodies.

First, the number of specific grants has been reduced, with funding being rolled into general grant funding. More significantly, responsibility for funding and commissioning local public health services – which includes tackling obesity, smoking, substance misuse and the provision of sexual health services – was transferred from the NHS to councils in 2013–14. Funding for this service comes in the form of a ring-fenced grant from the Department for Health, but councils have discretion on how to allocate it between public health services. In the same year councils also took on the responsibility for funding and designing schemes to help those with low incomes pay their Council Tax bills.<sup>18</sup>

Devolution, city, and growth deals have also devolved responsibility and powers over certain areas of public expenditure to certain parts of England. The deals differ in scope and scale,<sup>19</sup> but cover things like post-16 education and skills, additional transport responsibilities, strategic planning, and active labour market policies. It is perhaps in Manchester where things have progressed furthest, where the Greater Manchester Health and Social Care Partnership, which includes local councils, NHS bodies and the Greater Manchester combined authority, now oversees the £6 billion health and social care budget for the city-region.<sup>20</sup>

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In other areas though, there have been increasing restrictions on local spending autonomy. This includes social care, schools and arguably (in practise, if not in principle) health.

#### Social care – a creeping centralisation?

Looking first at social care, the Care Act 2014 introduced new national regulations governing eligibility and assessment for publicly funded social care services. It also placed new statutory duties on councils to provide a number of specific services.<sup>21</sup> Alongside this, the government has also ring-fenced a growing pot of money specifically for adult social care services. This includes transfers from the NHS via the Better Care Fund, grant funding from central government via the so-called Improved Better Care Fund, and part of the revenues from Council Tax increases (the social care precept). These revenue streams could amount to £5.3 billion in today's prices in 2019–20 (perhaps 30% of councils' overall spending on adult social care), up from virtually nothing in 2011–12 (Amin-Smith et al, 2018a).

Broadly speaking these ring-fenced revenues are allocated in accordance to the assessed spending needs of different areas. Alongside the new centrally imposed service standards, this suggests the government is aiming for a more consistent standard of service across the country and is using centralisation to achieve this. Indeed the then Secretary of State for Health and Social Care said in March 2018 that the government wished to tackle what he termed “unacceptable variation in quality and outcomes” in different parts of the country (Department for Health and Social Care, 2018).

<sup>18</sup> Central government imposed one key condition on these schemes: they had to be at least as generous as the previous national scheme in the case of adults aged over the state pension age. More generally though councils have free reign to design their own schemes, and there soon developed significant variation in the generosity and design of schemes across the country. See Adam et al (2014).

<sup>19</sup> A summary of the deals is available at <https://www.local.gov.uk/topics/devolution/devolution-deals>.

<sup>20</sup> It is not clear how this differs in practise from joint working arrangements encouraged by the government in the rest of England via the Better Care Fund and Sustainability and Transformation Plans though.

<sup>21</sup> These include information and advice services available to all; support for those providing informal care to friends or relatives; clear personal budgets for those receiving care; independent advocates for those unable to engage with the assessment and care process themselves; and deferred payment schemes.

### **Schools – removing local government from the formula?**

For schools, recent years have seen the centralisation of decisions over local spending levels, but devolution of additional responsibility and powers to individual schools over how they spend their own budgets. Since 2006–07, funding for schools has been ring-fenced as the Dedicated Schools Grant (DSG). The size of this grant therefore represents a hard floor below which school spending cannot fall, and while councils can top up the DSG from their own revenues, very few do this in practise (Sibieta, 2015). The Department for Education also plans to introduce a national funding formula for schools, whereby schools with the same characteristics would eventually receive the same level of funding wherever they are in the country (Department for Education, 2017).

Difficulties in moving to such a formula at a time of restraint on overall government spending, including schools spending, mean that it is not due to be implemented until after 2020. But it would represent a significant centralisation of powers that have long been locally-held. It again suggests the government is keen to ensure more consistent funding and standards of schooling across the country.

Recent changes have increased the discretion of individual schools over how to spend their budgets though. The Academies and Free Schools programmes means increasing numbers of schools receive funding directly from central government, including for services that would previously have been provided by their councils. These schools also have more flexibility over what they teach, and over the pay and terms and conditions of staff than other schools.

### **Health – hospital deficits increasing central leverage?**

At an organisational level, the main changes to the NHS have been the replacement of the Primary Care Trusts with fewer and larger Clinical Commissioning Groups (CCGs), and the increasing number of hospitals and other trusts obtaining “Foundation” status, which means additional financial freedoms. However, in practise, the growing number of hospitals and other trusts running deficits means that central government has been able to exert additional control over local health policy and operational decisions.<sup>22</sup>

### **Local government more reliant on still-limited tax revenues**

Large cuts to grant funding and the partial devolution of business rates revenues to councils under the business rates retention scheme (BRRS) mean that the share of local government funding that comes from local taxes has significantly increased in recent years. Excluding funding for schools (which increasingly bypasses councils altogether), the share of revenues coming from local taxes increased from 40% in 2009–10 to 70% in 2016–17 and is set to be 76% in 2019–20 (Amin-Smith et al, 2018a, Appendix A).

Councils also have greater discretion over business rates reliefs and Council Tax rates on second and long-term empty homes (House of Commons Library, 2018). And since 2010, councils have also had the power to impose fixed Community Infrastructure Levies (CIL) on all new developments, supplementing their powers to negotiate bespoke contributions from developers under Section 106 of the Town and Country Planning Act 1990. As of the end of 2016–17, 133 out of a possible 339 were charging a CIL (Lord et al, 2018).

However, the degree of devolution remains limited. Decisions about the Council Tax base and relative tax levels of properties of different values remain nationally-determined. And the business rates tax rate (or ‘multiplier’) is centrally-determined, with plans for devolution of powers to reduce the tax rate from 2019–20 put on hold.<sup>23</sup> The government has also introduced a requirement for referendums for Council Tax increases above a particular threshold, with these thresholds set centrally (House of Commons Library, 2017a). And as already mentioned, part of these Council Tax increases is ring-fenced for adult social care services. The former Chancellor George Osborne’s claims that he was delivering a ‘devolution revolution’ does not ring true for tax revenues and powers (HM Treasury, 2015).

<sup>22</sup> This includes attaching strings to new funding streams such as £1.8 billion of sustainability and transformation funding in 2016–17 (see Department for Health (2015)). In addition, a National Emergency Pressures Panel coordinates responses to pressures on the NHS service and makes recommendations for hospitals and other trusts (for example, NHS England (2018)).

<sup>23</sup> These powers were contained in the Local Government Finance Bill 2016–17, which has not been resurrected after failing to pass before the June 2017 UK general election.

### Local government funding is increasing prioritising fiscal incentives

Where there is a more genuine revolution is fiscal equalisation. In particular, for councils' general funding there is a clear direction of travel: a greater focus on fiscal incentives for growth, even if that means greater scope for divergences between revenues and spending needs to develop.

There are a number of elements to this change. The New Homes Bonus, introduced in 2011, doubles the Council Tax councils receive from new homes for several years after their completion, in order to incentivise councils to approve and facilitate house-building (House of Commons Library, 2017b). The localisation of responsibility for supporting low income households to pay their Council Tax provides stronger incentives for councils to boost employment and local incomes (and, less desirable, discourage poorer households from locating in their area).

More significantly, the process for allocating grants to councils has been changed in ways that reduce the amount of redistribution. First, the so-called Four Block funding model, introduced in 2006-07, and in place until 2013-14, no longer aimed for the full compensation for differences in revenue-raising capacity and spending needs. Instead weights applied to the various 'blocks' could be adjusted, leading to different degrees of equalisation.<sup>24</sup> Then, in 2013-14 the annual updating of the underlying assessments of revenue-raising capacity and spending needs was ended. Instead, councils' grants have either been cut by the same proportion (as in 2014-15 and 2015-16) or been cut in such a way as to deliver the same proportionate cut in overall spending power, taking into account initial Council Tax revenues (2016-17 and later).<sup>25</sup> Doing this provides stronger incentives for councils to boost Council Tax bases and tackle underlying spending needs.

The biggest change is the Business Rates Retention Scheme (BRRS) though. Since its introduction in 2013-14, local areas have borne up to 50% of the real-terms change in business rates revenues, except for those resulting directly from central government policy changes and the revaluation of properties in April 2017.<sup>26</sup> The aim of this is to provide councils with incentives to support the development and improvement of nondomestic property, and more generally promote economic development. However, at the same time it increases the risk for divergences to open up between revenues and spending needs given that business rates revenues can evolve in a different way to spending needs over time. Alongside the ending of the more general annual equalisation of revenues and spending needs, this could make it more difficult to deliver a consistent standard of service across England for those services funded by councils' general revenues. This includes children's social services, most funding for adult social services, and potentially public health if plans to abolish general grant funding and the public health grant in 2020-21 come to fruition (Ministry of Housing, Communities and Local Government, 2018).

“Increases in the share of business rates retained would further strengthen the incentives for revenue growth, but would also likely increase the risk of divergences”

Alongside the abolition of these grants, the government plans to increase the proportion of changes in rates revenues retained by local areas to 75% in 2020-21. In addition, it is piloting 100% in councils covering around half of England in 2018-19 (Amin-Smith et al, 2018c). Increases in the share of business rates retained would further strengthen the incentives for revenue growth, but would also likely increase the risk of divergences between revenues and spending needs, although the policy design details can have a significant effect on the scale of divergences.<sup>27</sup>

24 The impact of these block weights was far from transparent. For instance, if the weights were not updated over time as overall levels of grant funding changed, the degree of equalisation delivered would also change over time. Indeed, alongside the knock-on effects the 'damping' block, this issue meant that by the time the model was abandoned in 2013-14, it arguably had broken down. See Gibson and Asthana (2011) and Amin-Smith et al (2016).

25 The proportionate cuts varied by type of council.

26 The exclusion of changes in rates revenues that result from revaluation means that the BRRS effectively incentivises increases in the quantity and physical quality of floor space, rather than increases in the value of floor space. The rationale and implications of this are discussed in Amin-Smith and Phillips (2017). It is also worth noting that Amin-Smith et al (2018b) finds that there is little relationship between the business rates tax base and wider economic performance once valuation changes are stripped out of the tax base.

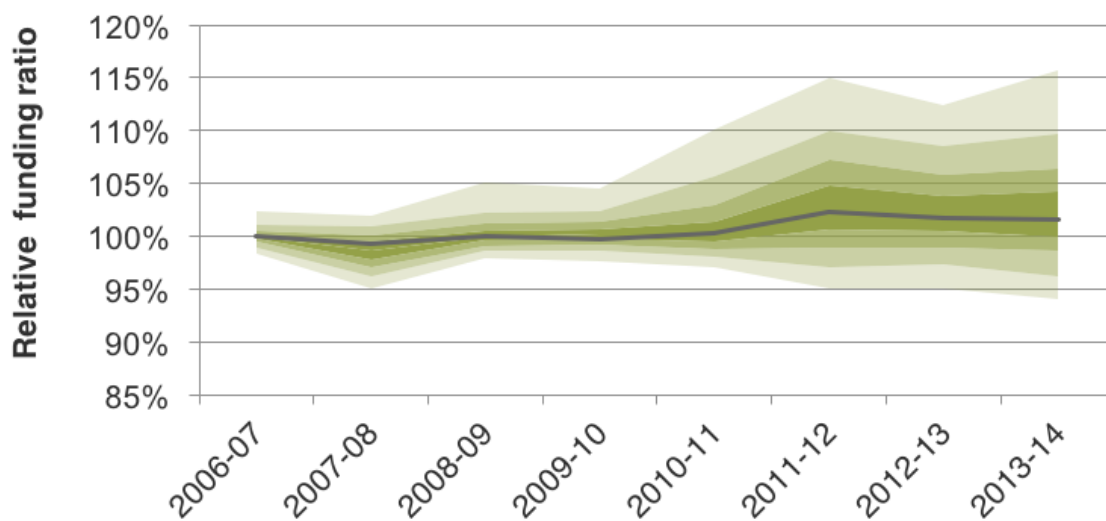
27 Amin-Smith et al (2018b) shows that the way changes in business rates revenues are shared between counties and districts in areas of England with two-tier local government can have a significant effect on divergences in these areas, for instance.

### Quantifying the funding divergences that could accompany the incentives

The divergences will depend on how revenue-raising capacity and spending needs evolve over time as well. While we cannot know how they will evolve in future, we can use historic figures to get a sense of the potential scale of divergences, as in an IFS report published in March 2018.<sup>28</sup> In that report, council level figures on revenue-raising capacity and assessed spending needs from 2006-07 to 2013-14 were fed through a model of a 100% BRRS, to calculate what each council's retained revenues could have been if such a funding system had been in place since the start of that period. To examine the scale of divergences, what was termed the relative funding ratio of each council was estimated. It measures the proportion by which a council's share of retained revenues is higher (>100%) or lower (<100%) than its share of assessed relative spending needs. The more dispersed are these relative funding ratios, the greater are divergences between councils' shares of retained revenues and their shares of assessed needs.

Figure 2 shows the distribution of relative funding ratios for each year between 2006-07 and 2013-14 for a version of the 100% BRRS. It is a fan chart: each pair of same-coloured bands represents 20% of councils, with 10% of councils above and 10% below the lightest bands.

**Figure 2: Distribution of councils' relative funding ratios (2006-2007 to 2013-14) under a 100% BRRS with a safety net and a split of 80% to counties and 20% to districts in two-tier areas**



Source: See Figure 4.4. of Amin-Smith et al (2018b).

It is clear that there would be growing divergences in relative funding ratios over time as revenues and spending needs evolve. For instance, in 2006-07, following the initial set up of the system, eight-tenth councils would have a relative funding ratio of between 98% and 102.5%. This narrow range reflects the fact that the BRRS involves transfers between councils with high revenues to those with high needs. However once set, year-to-year those transfers are only uprated in line with inflation, and are not adjusted as tax revenues and spending needs change (if they were it would remove the incentive to boost revenues and reduce spending needs). As a result of subsequent changes in tax revenues and spending needs, by 2013-14, eight-in-ten councils would have had a ratio between 94% and 116%: a much wider range. Such a widening in the dispersion of relative funding levels of different councils could make achieving a consistent standard of local public services across the country more difficult: that is the price of the stronger incentives delivered by the BRRS and the ending of annual updates to assessments of Council Tax revenue-raising capacity and spending needs.

<sup>28</sup> Amin-Smith et al (2018b). Section 4 provides a fuller explanation of the analysis described in the next two paragraphs and illustrated in Figure 3.

The results reported in Figure 2 are based on a system with a ‘safety net’ that tops up the revenues of councils seeing their business rates revenues fall below 97% of a pre-determined baseline. Such a safety net blunts the incentives of councils in receipt of it to grow their business rates revenues: as they do they lose safety net payments. But it can prevent the largest falls in revenues. Amin-Smith et al (2018) shows that in 2013-14, the lowest relative funding ratio with a safety net would be 87%, which compares to 61% without a safety net. As it develops its business rates policy, the government therefore faces a trade-off between insulating councils from big declines in their revenues, and potentially creating a ‘poverty trap’ for councils that then no longer have incentives to boost their own revenues.

In addition to the safety-net, the government plans to limit divergence by periodic resets of the redistributive transfers between councils (via what are termed ‘tariffs’ – on those with high revenue/low needs – and ‘top-ups’ – for those with low revenue/high needs). The more frequent and the fuller these resets, the more they will do to reduce the scale of divergences between revenues and assessed spending needs. However, that also weakens financial incentives to grow revenues and tackle spending needs as the resets would offset the financial gain from such efforts.

The government therefore faces another tricky balancing act between redistribution and incentives for councils in the design of the BRRS. In its February 2017 consultation, the government suggested partial resets every five years, and this found significant support from local government (Department for Communities and Local Government, 2018b). However, there was no indication of how partial it was thinking the resets should be (i.e. whether the resets should offset 25%, 50% or 90% or some other fraction of the changes in revenue-raising capacity and spending needs), which would make a significant difference to both incentives and funding divergences.

#### **A renewed focus on equalisation for schools and the police**

What about other local services? Here the picture is different, with a renewed focus on equalisation for schools and the police. The National Funding Formula for schools can be thought of as full needsbased equalisation. The initial phase involves updating the DSG provided to each council on the basis of local needs indicators. This follows a 15 year period during which schools funding allocations to councils have effectively been updated for changing pupil numbers, but not other indicators of needs (like deprivation levels). The full rollout of the school-level formula will mean school funding will reflect regularly updated information on school and pupil characteristics. A similar situation pertains in police, where since 2006-07 the data used in the existing formula has not been consistently updated, and changes in grants have been heavily ‘damped’ in any case. The government has consulted on reforms to the formula, but the proposed changes were put on hold in 2015 following errors in the information shared with police. However, the government maintains it is committed to reform of the formula (House of Commons Library, 2017c). Finally, for the NHS, funding continues to be allocated according to a needs-based formula, which is regularly updated.

“The government faces a trade-off between insulating councils from big declines in their revenues, and potentially creating a ‘poverty trap’ for councils that then no longer have incentives to boost their own revenues”



#### 4. DISCUSSION AND CONCLUSIONS

Considering the changes to the degree of expenditure and revenue devolution and fiscal equalisation together, what can we say about the government's plans for different local public services? And what are the main policy options for the future division of responsibility between local and central government?

Looking first at schools and health, there seems to be a reasonably clear policy of centrally determining the overall funding levels for different local areas, combined with a high degree of fiscal equalisation. These funding systems therefore seem aimed at supporting the local organisations delivering services – schools, hospitals and surgeries – to deliver a consistent standard of service nationally, irrespective of local revenue-raising capacity and needs. Of course, it means these local bodies do not have direct financial incentives to boost local revenue-raising capacity or tackle underlying spending needs. And the fact that these bodies are bureaucratic rather than political means there is limited direct accountability to local voters. Instead, accountability is based on a series of centrally-driven targets (such as waiting times targets) and indicators (such as school league tables), and through commissioner-provider relationships (such as between clinical commissioning groups and hospitals).

“One cannot have both discretion and consistency; local responsibility and national standards”

The NHS and schools are probably the most important and salient public services to both the electorate and politicians. The primacy placed on national standards may reflect this salience and the idea that access to these services is a ‘right’ for all citizens/residents. Equality of access therefore trumps the benefits of local discretion, accountability and incentives. Policy changes and rhetoric suggests that adult social care services are increasingly seen in this way as well. The introduction of new national standards for assessment, eligibility and service offerings, and ring-fenced funding streams based on assessed spending needs all point towards a desire for more consistent standards across England. So do the pronouncements from the Secretary of State for Health and Social Care (the latter a responsibility only added to the Secretary's portfolio in January 2018).

However, reforms to the general local government finance system – from which the bulk of adult social care funding is still due to come – are pulling in the opposite direction. Here the government seems willing to tolerate greater divergences in funding – and likely service standards and offerings – in order to provide stronger financial incentives for revenue growth and the tackling of spending needs, and greater accountability to local taxpayers. Such a policy position is neither illegitimate nor internationally unusual, with many countries having longstanding differences in service provision and design across local or regional governmental units, based on differences in revenue-raising capacity (and local preferences).<sup>29</sup> But one cannot have both discretion and consistency; local responsibility and national standards. Indeed, one could go as far as to say that the government's adult social care and local government finance policies are inconsistent and conflicting.

Moreover, it is not clear what the government's objectives are in relation to children's social services and public health – other areas which one might expect equity concerns could lead to one wanting consistency in standards and service offerings across the country. The government clearly cares about standards of these services: following poor inspection results, children's social services were removed from the control of the local councils in Doncaster and Slough.<sup>30</sup> But unlike for adult social care, there has been no specific funding for children's social services, and the ring-fenced grant for public health is set to be abolished in 2020-21 at the point councils move to 75% business rates retention.

<sup>29</sup> This is true both of federal countries (like the US, Canada and Switzerland) and unitary ones (such as Denmark or Portugal).

See Blochliger et al (2007).

<sup>30</sup> They are now run by children's services trusts, which are run by a board of executive and non-executive directors appointed by the Department for Education.

So what are the broad options available to the government if it wants more coherence between its financial and broader policy plans for local services?<sup>31</sup>

- 1 The government could continue with existing plans. This would likely see further schools becoming directly funded by central government, with funding being allocated according to a common national formula. The ring-fenced grant the government gives councils to help fund their adult social care services would likely have to increase significantly over time as demand for social care outstrips growth in Council Tax and business rates revenues. As this grant funding paid for a larger and larger share of adult social care services, central control of funding would increase (and local discretion fall), and these services would become less exposed to the revenue risks associated with the BRRS. Over time, we would then see a creeping centralisation of social care funding, which could help deliver national standards, but would come at the cost of reducing local discretion. However, in the medium-term, with the bulk of funding for adult social care services coming from councils' general revenues, there would be a risk that divergences between revenues and spending needs could make achieving consistent national standards more challenging. And with spending pressures for children's social services and public health also building (Local Government Information Unit, 2018) it seems likely that grants to top up councils' own tax revenues would be required for these services as well. That is, the creeping centralisation for adult social care could be replicated for other services, slowly hollowing out local government.
- 2 If consistency in service offerings and standards is paramount, rather than centralise funding decisions slowly and stealthily, the government could be more proactive and upfront. In particular, it could fully centralise funding for adult social care services (and potentially other services), providing funding to councils – or perhaps other delivery bodies like health and social care trusts – via a ring-fenced grant that is similar in form to the DSG. This would allow the government to allocate funding to these services on the basis of the assessed spending needs of different areas – eventually: there are currently large gaps between assessed spending needs and actual spending levels, so any move to needs-based grants would likely require a long transition period.<sup>32</sup> And if the government wanted to undertake this centralisation in a revenue neutral way it would either have to devolve other services to be funded by councils' tax revenues, and/or extract a proportion of those tax revenues to help pay for the new dedicated adult social care grant (or DASCG). However, it would be important to recognise that such a centralised approach to funding would necessarily mean a big reduction in local discretion over public spending, and less direct accountability to the local electorate.
- 3 The government could retain such discretion and accountability by reversing course on plans to abolish general grant funding. Instead, over time, these grants could be increased which, as with ring-fenced grants, would reduce the overall exposure of councils' budgets to risks associated with the BRRS. In principle this would help councils to deliver consistent standards of service across the country – if that is what they wanted to do. Because councils could use this discretion to prioritise expenditure on different services and local Council Tax levels in different ways. In this context, the statutory duties placed on councils can only go so far in delivering a more consistent standard of services across the country, given the legitimate variation in how these duties are interpreted by councils, and the flexibility to offer services that exceed statutory requirements.

<sup>31</sup> The following section draws heavily on Amin-Smith et al (2018a).  
<sup>32</sup> See Amin-Smith et al (2018a) for further discussion.

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4 Finally, the government could significantly increase local discretion by halting plans for a national funding formula for schools, ending the ring-fence on the DSG, and ramping up the devolution of health services that it has taken the tentative first steps on in Greater Manchester. This would enable local politicians to set priorities across local public services, and may facilitate closer integration of services (e.g. through alignment of financial incentives and governance structures). This discretion would be expected to lead to greater variation in service offerings around the country as different areas make different decisions. But, there is tentative evidence from the academic literature that devolution is associated with higher quality services. Additional expenditure devolution would also make additional revenue devolution more practicable. This could include a proportion of income tax and/or corporation tax, as well as a local sales tax. Doing this could provide a broader set of financial incentives to councils to boost local economic growth (rather than just property development as under the BRRS). Without further expenditure devolution to councils, revenue devolution would need to be accompanied by a means to extract part of existing revenues from local government to pay for centrally-funded services.

Which of these choices the government makes will have quite profound effects on the type of country England is: a highly centralised country, with limited local discretion and accountability, but funding aimed at providing consistent services nationally; a highly decentralised country, with substantial local discretion and accountability, but service standards that can differ as different areas prioritise differently; or somewhere in between. The answer chosen might differ for different service areas. However, whatever route is taken, it is important that the funding system in place is in accordance with broader policy aims around equity, incentives and discretion. And that policy matches the rhetoric. As it stands, for one key service area at least – adult social care – funding policy and broader policy objectives and rhetoric are not aligned. That is a recipe for potential policy failure, as well as public disillusionment.

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# 4 An exploration of the issues raised by the move towards 100% Business Rate Retention

## INTRODUCTION

In October 2015, the then Chancellor of the Exchequer announced a ‘devolution revolution’: a commitment to allow local government collectively to retain 100 per cent of business rate revenue by the end of the Parliament in 2020. This move was intended to support the policy of devolving freedoms and flexibilities to local areas in England and the policy of localism, under which decisions on spending are taken locally according to local priorities. As a consequence, the Revenue Support Grant, the main central government grant for local authorities, is to be phased out by 2019-20, although this policy goal has not been formally restated by recent Secretaries of State.

The move to 100% business rate retention is the most recent change to the local government finance system. It is intended to incentivise local authorities to increase local economic growth, thus increasing their income. The Ministry of Housing, Communities & Local Government (the Department) has also introduced changes to the funding system for local authorities. Its aims are 1)

to give authorities greater flexibility in how they use their funding and 2) incentivise local authorities to increase income and reduce the costs of meeting social needs. Core changes include:

- **50% business rates retention scheme** From 1 April 2013 local authorities retained up to half of any local growth in business rates. The Department also stopped revising its distribution of annual grant funding according to updated assessments of need.
- **New Homes Bonus** Since 2011-12, local authorities received extra funding for every new residential property in their area. The Bonus is mostly funded by reallocating a portion of revenue support grant, meaning that while some authorities will gain, others will lose.
- **Council Tax support** In 2013-14 the Department devolved responsibility to local authorities for subsidising poorer households’ Council Tax bills, while cutting funding by 10%.

The move towards 100% business rate retention in England raises numerous issues about whether business rates are a suitable way to fund local government. One key problem for example is balancing the demand for services against the uncertain local yield from business rates. This article explores the various challenges which will need to be addressed if the government’s aim for local government financial self sufficiency, based partly on business rates, is to be successful.

## WHAT IS BUSINESS RATE RETENTION?

Business rates comprise an important component of local government finance: i.e., the total income of the local government sector in any given year. Local government income is made up of central government grant, Council Tax, business rates and locally raised income; comprising for example, fees and charges, income from commercial investments and so on. The balance between the components of local government finance are changing over time: from 2010, the government started to reduce the revenue support grant and to introduce incentive mechanisms including business rate retention.

“One key problem is balancing the demand for services against the uncertain local yield from business rates”

## CHANGES TO THE LOCAL GOVERNMENT FINANCE SYSTEM SINCE 2010

Since 2010, local authority funding has changed substantially in terms of size, source and the conditions attached to various funding streams. In the 2010 spending review, the government said it wanted to increase local authorities' flexibility over how they could spend their funding. The government wanted local authorities to be able to respond to local priorities, rather than being directed by the aims and conditions that central government placed on spending. The government intended to provide local authorities with flexibility to fulfil their statutory duties despite the funding reductions begun in 2010 and leading to the end of revenue support grant by 2020. These changes accelerated the trend of previous governments to increase local authorities' financial flexibility by reducing the number and value of ringfenced grants. The government also wanted to reduce the reporting burden for local authorities.

The Localism Act 2011 achieved two things: firstly, it granted all local authorities a 'general power of competence' meaning that councils are able to follow any course of action so long as it is legal. Secondly, the Ministry of Housing, Communities and Local Government (the Department) changed the funding system to allow authorities greater flexibility in how they used funding under the Local Government Finance Act, 2012. Their other intention was to incentivise authorities to increase their income and reduce the costs of meeting social needs. The Department also stopped revising its distribution of annual grant funding according to updated assessments of need thereby starting to sever the link between revenue support grant and social need. Core changes included::

### Setting up of the business rates retention scheme

From 1 April 2013, local authorities in England retained up to half of any local growth in business rates. In 2016-17, authorities gained an additional £388m from the scheme from growth in revenues and £11.3 billion was retained by the sector, redistributed by the Department. The other half - the central share - is then largely returned to local authorities through grants. The total yield from business rates is around £22 billion. The 50% scheme has a reset mechanism designed to remove divergence periodically but has not been used to date. The aim is to allow local authorities with growing tax bases to benefit from growth between resets, while ensuring that those with declining business rates receive protection periodically by resets and those suffering a sudden fall in one year or historically lower levels, by the safety net.

### Introducing the New Homes Bonus

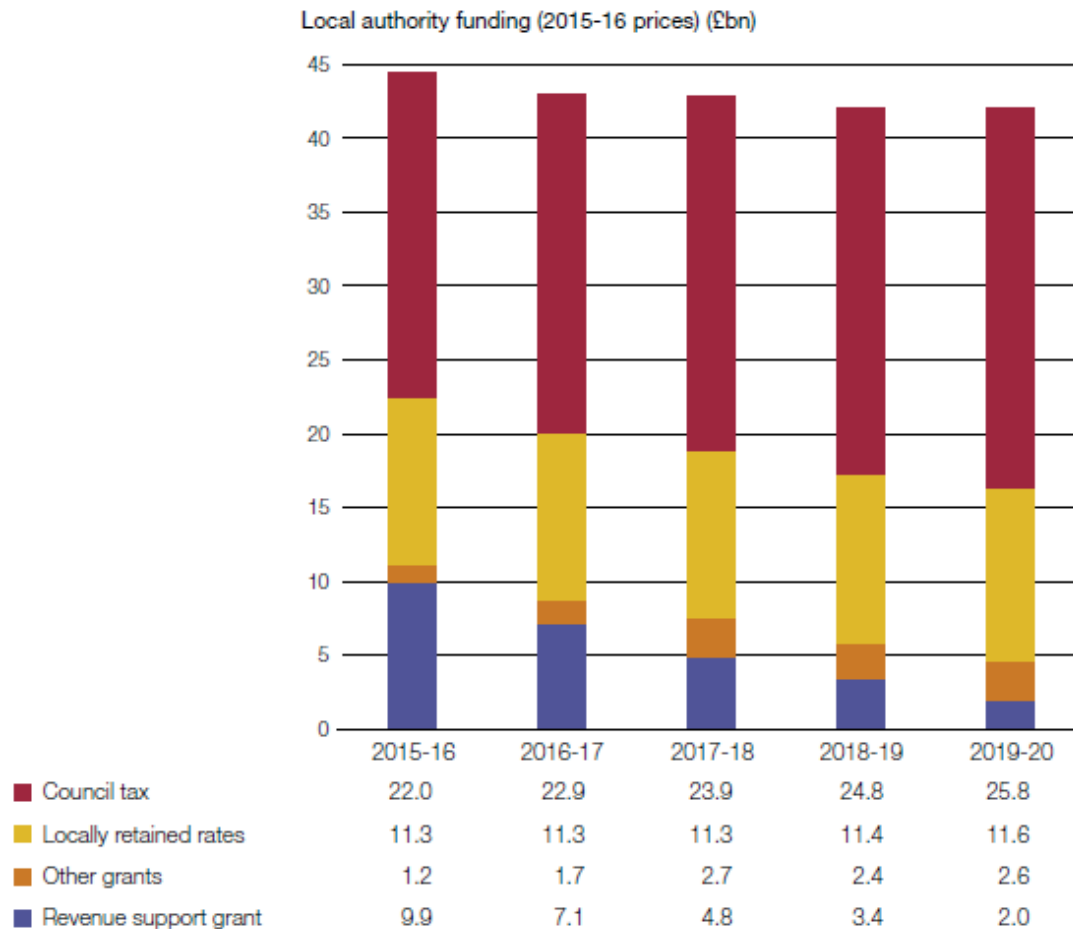
Since 2011-12, local authorities received extra funding for every new residential property in their area. The Bonus is mostly funded by reallocating a portion of revenue support grant, meaning that while some authorities gained, others would lose because the Department funded the New Homes Bonus by taking a portion of revenue support grant before the remainder was distributed to local authorities. The bonus was designed to incentivise housebuilding and add to housing supply through authorities' granting planning permissions and encouraging developers to build..

### Council Tax support

In 2013-14 the Department devolved responsibility to local authorities for subsidising poorer households' Council Tax bills, while cutting the available funding by 10%.

The components of local government finance have changed since 2010 and will continue to change until 2020. The figure below from a recent National Audit Office report shows this change for the 5 years to 2020. The chart shows the revenue support grant gradually diminishing until its expected demise in 2020. The second point to note is that Council Tax is becoming a greater proportion of income, meaning that local tax payers are funding a larger proportion of service spend. From 2012-13 the government limited rises in Council Tax to 3.5% in the first year and 2% per year thereafter. If a council wanted to raise Council Tax more, they would have to hold a referendum to seek a democratic mandate. Now, even though Council Tax limits have been raised several times, the resulting increase in revenue over and above the 'core' precept, has to be spent on adult social care ('the adult social care precept') laid down by the Department of Health and Social Care. This is intended to reduce pressure on the NHS; thus, a council may have greater revenue but less discretion on how to spend the money. This runs counter to the policy of localism. The key point from the chart is the increasing importance of business rates to the sector as a whole and also to individual councils.

**Change in components of core spending power, 2015 to 2019-20.  
 Core spending power will fall until 2018-19, then rise slightly**



Source: National Audit Office analysis of Department for Communities and Local Government data

## WHO PAYS BUSINESS RATES?

Business rates are charged on most types of commercial property in a local area, according to a national rate set by the Ministry of Housing, Communities and Local Government against property valuations set by the Valuation Office Agency.<sup>1</sup> Business rates are a charge on most non-domestic properties. They are collected primarily by local ‘billing’ authorities. These include metropolitan district councils, London boroughs, unitary authorities and district councils. Billing authorities pass fixed proportions of retained business rates to major precepting authorities – county councils, fire and rescue authorities and the Greater London Authority. Business rates are essentially a property tax on commercial property, levied on most buildings with exemptions for some types of property such as agricultural property and student accommodation.

There are two major issues intertwined in the move towards 100% business rate retention: 1) taking the doctrine of localism further and 2) spending to reflect the needs of their populations. Raising business rates locally and, by extension, encouraging local businesses to expand and new businesses to start, should contribute to making places more successful and vibrant and, for local authorities to lead in ‘place shaping’ in the cliché often used. The Localism Act gave local authorities a ‘general power of competence’. This can and does include activities such as investing in joint ventures, setting up wholly owned companies, lending money to each other or their public bodies and undertaking commercial-style trading activity.

<sup>1</sup> VOA is an executive agency of HM Revenue & Customs



The second goal for business rate retention as a policy is to move towards the financial self-sufficiency of the local government sector as a whole. The main purpose as stated by the Secretary of State and HM Treasury in 2015 was that the sector should aim for financial self sufficiency by 2020 and retaining all business rates would be a key part of this move. The year 2020 is also intended to be the year in which revenue support grant ceases, so councils will be funded from local sources: Council Tax, business rates and locally generated income. In essence it sounds simple: local government will retain all taxes raised from their businesses locally. However, as ever with local government finance, it might be simple in principle but far less so in practice. One complexity for example will be which of the existing other grants such as the Public Health Grant will survive the Spending Review in 2019.

The implementation of business rate retention raises a number of confounding issues and difficulties in the short and medium term for the Department, for local authorities and for government as a whole. The challenges vary - from the question of funding social services from a business tax to the practical challenges of running the scheme. The Department has set up pilots with a range of authorities over the last two years to learn what the practical difficulties might be of the full scheme

### CHALLENGE 1 : FUNDING SOCIAL CARE FROM BUSINESS TAXES – NEED VS. YIELD

The biggest councils, the single tier and county councils, provide social care services on a meanstested basis to adults who need help with the daily tasks of living: washing, dressing, eating, and shopping and so on. Some people need only a small amount of help to maintain their lives in their own home while at the other end of the spectrum there are those with severe life limiting conditions like dementia or Parkinson's disease who need 24 hour care in special facilities. Under the Care Act 2014, all those with substantial or critical needs should have these needs funded. The other main provision is for children who are at risk of harm: support here varies from assessment through to being looked after by the state until they reach the age of 18. In both adult and children's social care, care needs tend to be long lasting and tend not to diminish with time.

“Need and business rate yield are not correlated”

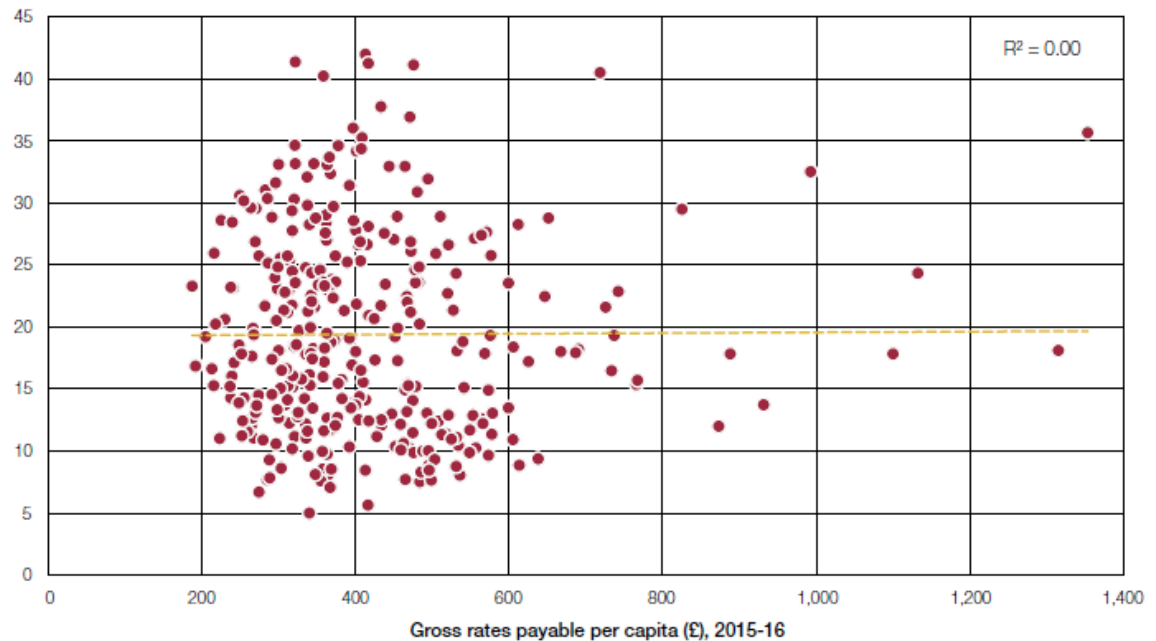
The first and perhaps the most profound challenge to business rates then is whether it is the right tax to fund social services for the most vulnerable

whose needs are ongoing and cannot be met other than via state funding. Business rates yield varies between areas through accidents of history and geography. Important factors for rates yield will include how built up an area is, the proportion of commercial rather than domestic property in an area, how rural it is and the wider picture of economic activity. The size of the social care spend relates to need which is connected with levels of deprivation. Need and business rate yield are not correlated. The chart below from the NAO's report shows this lack of a relationship. Plotting levels of deprivation against gross rates payable per capita by billing authority shows that there is no relationship between the two. Unless, as a society, we are happy for the post code lottery to play out in a way that would show marked variations between service provision in different areas next door to each other, then using business rates as a major part of local funding means that there has to be a mechanism for redistribution from areas of high yield to those with low, currently achieved by means of the system of tariffs and top ups.

### Level of deprivation and gross rates payable per capita by billing authority

The scale of an area's business rates tax base (per capita) does not necessarily match its level of need for local services

Indices of multiple deprivation (average score), 2015



Notes:

1. See separate Methodology document for details of data sources and methodological approach
2. The dotted line is a regression line which shows no correlation between the two variables

## CHALLENGE 2: VARIABILITY IN THE FINANCIAL POSITION OF LOCAL AUTHORITIES

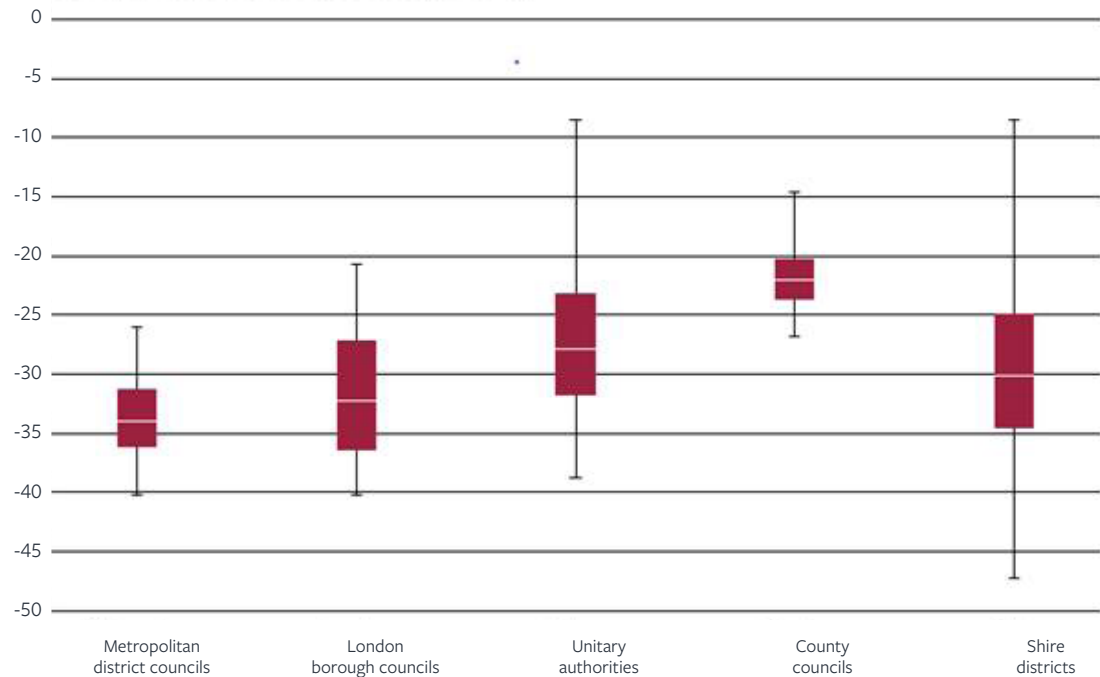
The NAO report in 2014 on the financial sustainability of local authorities investigated how government chose to reduce support to local authorities by removing whole grant programmes amongst other measures. The report highlighted variable effects across local government which are then amplified by the historical differences between areas. Authorities that depended most on government grants were affected most by government funding reductions and reforms. In principle, more grant-dependent authorities are more likely to be affected by the totality of funding changes, since grants make up a larger share of their budget. This outcome resulted from policy decisions to tackle the fiscal deficit by reducing public spending. This chart from the NAO's report on the financial sustainability of local authorities 2018, shows the change in spending power by type of authority and the variability of impact continuing.

“Authorities that depended most on government grants were affected most by government funding reductions and reforms”

### Change in spending power by type of local authority in England, 2010-11 to 2017-18

There is variation in the level of reductions in spending power both between and within different local authority types

Change in spending power 2010-11 to 2017-18 (%) (real terms)



Note: The white line in the centre of each block shows the median. The top and bottom of each block show the upper and lower quartiles respectively. The top and bottom error bars show minimum and maximum values respectively

The Department modelled the effects of different scenarios for future local government income which suggested that the most grant-dependent authorities would still have the largest cuts in spending power, even if they experienced strong local growth in business rates. This is because of the relatively lower share in the income of grant-dependent authorities made up by other sources, such as business rates. The conclusions from this work emphasise the need for a continuation of equalisation and redistribution of resources under any alternative system of local government finance and that business rate income is not a solution and may well exacerbate differences between areas.

Another complexity arising from the scheme comes from appeals against business rate decisions, especially by large companies with large bills which, if decisions were reversed, would have a material effect on an authority's finances. This has led to the creation of large provisions by finance directors meaning the amount of revenue funding available to an authority in a year was reduced until the appeal was settled. There was then a large growth in the backlog of appeals.

### CHALLENGE 3: INCREASED ECONOMIC ACTIVITY IS NOT LINKED DIRECTLY TO BUSINESS RATE GROWTH

By allowing local authorities to benefit from growth in their tax base, the government's expectation is that this should incentivise authorities to adopt planning and economic development practices that promote development and construction. This is expected to deliver economic growth in the form of jobs and increased economic output.

The link between tax base growth and economic outcomes is not direct. For instance, different types of development create different levels of economic outcomes and could lead to relocation of existing businesses from elsewhere rather than the creation of new ones. Or, an area could see increased economic activity which does not increase income to local authorities. An obvious example is an increase in student numbers. Councils do not get Council Tax income from students nor business rates from student accommodation. Or an area may house hi tech firms that need very little physical space.

Consequently, there is no correlation between change in an area's tax base and change in its economic output within the most recent revaluation period.

One complication is that business rates retention incentivises authorities to increase their tax bases, which is not the same as increasing economic growth. Increasing tax bases can come via increasing floor space locally for firms to move into; better management of ratings lists to ensure councils are maximising tax take or refurbishment of existing properties. While all of these are valuable, they are not necessarily directly pursuing economic growth.

The collection of business rates is done by district councils and single tier authorities on behalf of all authorities in an area and the yield divided. This creates perverse incentives because district councils are much smaller than single tier and county councils and have many fewer responsibilities.

The value of property changes over time so every so often, happening at semi regular intervals, the VOA revalue properties. The latest revaluation took place in 2017; around 1/3 of businesses stayed paying the same business rates; one third paid less and one third were subject to higher rates. Changes in the commercial value of properties due to wider economic growth are captured in periodic revaluations. However, these must be revenue-neutral nationally, which is achieved by adjusting the multiplier. Revaluations do lead to changes in the level of rates generated in each locality, but authorities' tariffs or top-ups are adjusted to ensure their retained income is the same after revaluation. As a result, authorities do not benefit from general economic changes in the value of existing property. If revaluations happen too frequently the incentive effect from increasing business rates can be lost, given the length of time major regeneration and infrastructure projects can take. The same is true for resets.

“Business rates retention incentivises authorities to increase their tax bases, which is not the same as increasing economic growth”

At the time when the NAO reported on the progress of the scheme to implement 100% business rate retention, the Department had not systematically examined whether the 50% scheme has incentivised behaviour which promotes economic growth. Such an evaluation would be complex because it would be difficult to control for the impact of the growth incentive in the context of other factors acting on local economies. Nevertheless, it is a gap in knowledge.

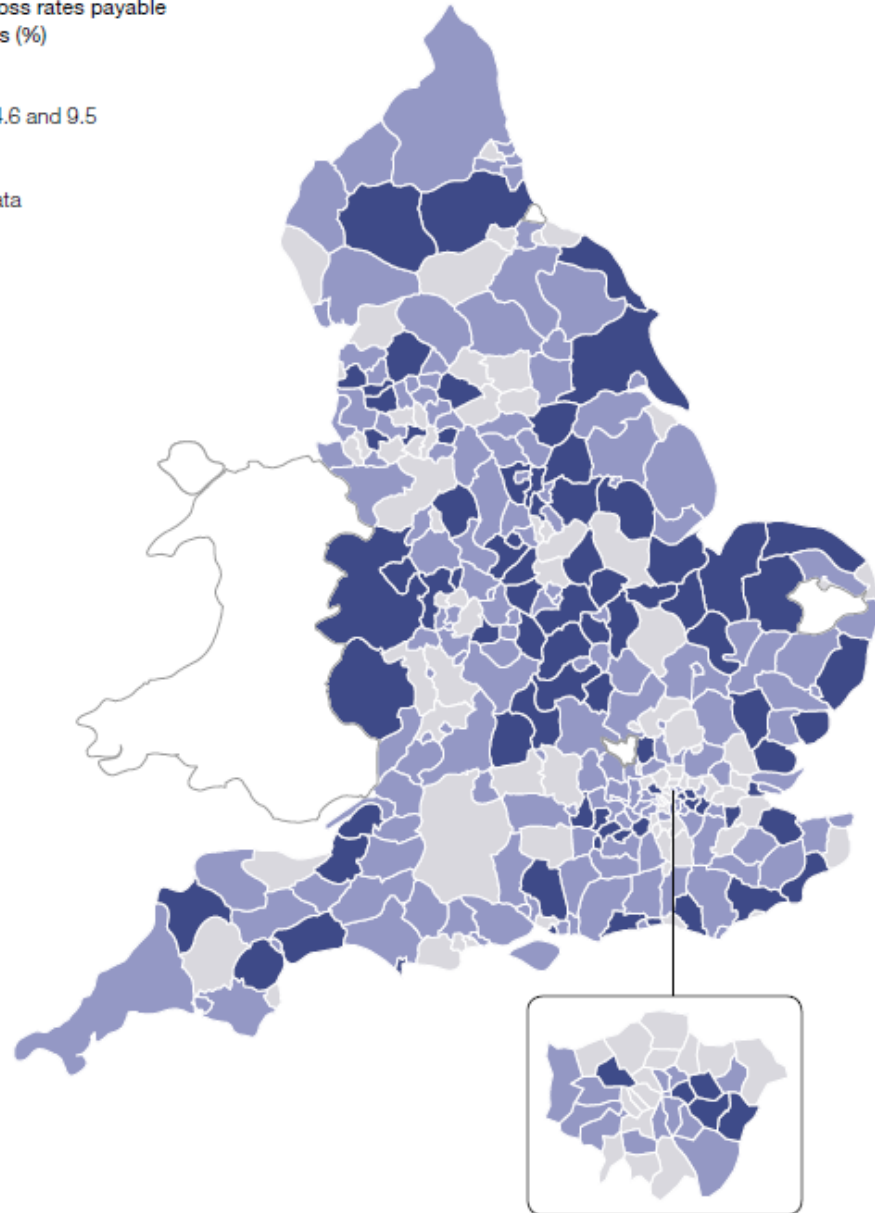
Many commentators are sceptical about the extent to which the 50% scheme had incentivised behaviour which promotes economic growth. These include the IFS and the House of Commons Library. Ultimately, it is not yet clear whether the scheme has incentivised authorities to adopt pro-growth policies, and whether any behaviour change has actually supported economic growth. Lastly, there is the question of the differential capacity for growth of different areas. The map of changes in the business rates tax base in England over the last 5 years shows no clear geographical pattern.

### Change in business rates tax base in England, 2010-11 to 2015-16

There appears to be no clear geographical pattern to growth in business rates

Change in gross rates payable  
 by rate payers (%)

- Above 9.6
- Between 4.6 and 9.5
- Below 4.5
- Missing data



Note: Data include billing authorities only.

### CHALLENGE 4: POLICY CHANGES COULD IMPACT THE AMOUNT OF MONEY AVAILABLE IN 2020 FROM BUSINESS RATES

The Department will have to develop an approach that allows it to design a fiscally neutral system in the context of uncertainty over ‘the quantum’ (total money) available to local government by 2020. And apart from uncertainty over the total available and whether local government will have to take on new responsibilities as well (part of the original plan), governments over time have granted various kinds of reliefs for various favoured causes. These include reliefs for small businesses, charities and so on which are intended for a variety of benign policy goals such as supporting local high streets. It is not clear that HM Treasury takes into account the potential effect on the local government sector as a whole or the loss of revenue to individual authorities at a granular level. This makes the quantum vulnerable to policy changes on the run up to 2020 or afterwards.

## CHALLENGE 5: THE STATE OF KNOWLEDGE ABOUT THE 50% RETENTION SCHEME

After the 2017 general election, the local government finance bill was not included in the 2017 Queen's Speech and therefore will not be put before Parliament. Inevitably, this casts doubt on the full implementation of the policy as originally envisaged. Nevertheless, the government is continuing to pilot aspects of the new system and finally announced in December 2017 that there would be an increase in retention, albeit 75%, not 100%. However, the Department's state of knowledge about how the system might work is not complete and these knowledge gaps could matter. These are the main knowledge gaps:

- The use of **ratings pools**, whereby income is distributed based on locally agreed principles amongst a group of authorities makes it difficult to understand which local authorities have benefited from the scheme. The Department's primary data set on business rates, the national non-domestic rates return, does not allow for the distribution of retained rates within pools to be calculated; effectively, we cannot see into pools and understand who have benefited most and why.
- The Department needs to understand the **factors underlying tax base growth**, and particularly how these affect the potential for growth in different local authorities. This then raises questions as to how the scheme can be designed to support economic growth in those areas that do not have favourable conditions.
- The **relationship between growth in the business rates base and local economic growth** needs to be much more fully understood than it is at the moment. For the system design to be most effective, the Department needs to understand what local authority behaviours might be incentivised by different arrangements.

“The local government finance bill was not included in the 2017 Queen's Speech”

## CHALLENGE 6: IMPLEMENTATION

The implementation of even 75% business rate retention scheme is complex and difficult, needing **expertise and experience**. If nothing else, the recent overpayment of £36m to pilot areas caused by an error<sup>2</sup> in a spreadsheet undetected by quality assurance within the Department illustrates that. Relevant experience is largely within the Local Government Finance Directorate but the staffing in this directorate has fallen by around 40% between 2011 and 2017 which raises the risk of a lack of resilience. The Department set up a series of working groups with the sector and has held a number of consultations to tap into sector knowledge.

There are a range of **granular decisions** on significant issues still to be taken, including the division of business rates within two-tier areas, the level of the safety net to prevent large falls and windfall rises, the proportion of growth that could be retained at a partial reset and precisely how a central approach to appeals would work.

Whether reductions in the **multiplier** in one area might boost local growth at the expense of others is a potential adverse consequence and needs analysis along with other options on multiplier flexibility. The business rates multiplier is the **rate** which when multiplied by the rateable value of a property determines a ratepayer's business rates bill. There are separate multipliers for small and larger businesses, and some rate reliefs that can be applied.

Time is an issue: the Fair Funding Review on a new distribution formula for local government is due to be implemented in 2020-21 at the same time as increased reliance on locally retained business rates. There are interdependencies between the two projects which need to be properly understood as do the implications of decisions in one project which could affect the other. Time is also an issue for the business rate retention pilots to ensure that knowledge from the pilots can be properly evaluated and understood. The Department needs to understand what effect decisions made now (especially for the whole London pilot) will have on the design of the new system.

<sup>2</sup> <http://www.bbc.co.uk/news/uk-politics-43484833>

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## CONCLUSION

Whatever is decided on the shape of the scheme to retain more business rates locally, it should be noted that the financial position of the local government sector has worsened markedly, particularly for authorities with social care responsibilities: the single tier and county councils. Local authorities will have seen their grant funding from central government reduce by over 50% by 2020. The latest report from the NAO has identified signs of real financial pressure. A combination of reduced funding and higher demand for services has meant that a growing number of single-tier and county authorities have not managed to stay within their service budgets and have relied on reserves to balance their books. These trends are not financially sustainable over the medium term. Financial resilience varies between authorities, with some having substantially lower reserves than others.

In 2016-17, the Department offered a four-year settlement to all authorities to enable better financial planning. However, there have been many changes to funding streams outside this core offer, such as the Adult Social Care Support Grant and a

second tranche of funding within the Improved Better Care Fund. Additionally, the government has announced multiple short-term funding initiatives and does not have a long-term funding plan for local authorities. The funding landscape following the 2015 Spending Review has been characterised by one-off and short-term funding initiatives. There is also uncertainty over the long-term financial plan for the sector. The absolute scale of future funding is unknown until the completion of the next Spending Review. The government has confirmed its intention to implement the results of the Fair Funding Review in 2020-21 and to allow local authorities to retain 75% of business rates. However, the implications of these changes are not yet clear. Financial uncertainty, both short term and long term, creates risks for value for money as it encourages short-term decision-making and undermines strategic planning.

Overall, though, the shape and coherence of the local government finance system – the whole mix, including capital financing, leveraging in private investment and extending commercial activity by local authorities - needs consideration, whether through the prism of retaining business rates or more widely.

“The financial position of the local government sector has worsened markedly”

Tony Travers

## 5

# Funding combined authorities and city regions

## A HISTORY OF COMBINED AUTHORITIES AND CITY REGIONS

The evolution of city regional government in Britain has a number of origins, not least of which was the growth of metropolitan areas during the Industrial Revolution. The fact that a number of big cities developed in the North and Midlands with several large towns nearby meant that railways, which were themselves an element of industrialisation, tended to radiate out from the centre of Manchester, Leeds, Birmingham and Sheffield to their surrounding towns. Trams and later buses followed the same pattern. Links were also built from these new metropolises to seaside towns and, of course, to London. This paper explains how city regional economies developed, embedding a series of defined urban areas where large numbers of people and businesses were concentrated.

Throughout much of the 19th century, these new cities and towns sought Parliamentary powers to set up municipal corporations (city-based all-purpose councils) with taxation powers. By 1900, most public provision was in the hands of these councils or special-purpose authorities. The UK government in London maintained an army and navy while administering the colonies and dominions. Local government and school boards were responsible for the provision of almost all early public services such as hospitals and schooling and set the property taxes which funded them.

During the 20th century the era of Empire drew to a close and the welfare state evolved. This led to a change of focus on the part of the UK government - away from Canada and India, towards Carlisle and Ipswich. The development of large 'social' services also brought with it the need for a public finance system which entailed a measure of redistribution between rich and poor areas. This new role of equalisation entailed an unprecedented financial role for central government in raising taxation revenues and funding social services such as expanding education and social care. In parallel, Britain rapidly de-industrialised from the late-1950s onwards, leading to job losses and economic decline in many of the older metropolitan areas.

“The development of large ‘social’ services also brought with it the need for a public finance system which entailed a measure of redistribution between rich and poor areas”

In the 1950s and early-1960s, structural reforms were proposed for, first, London and then the rest of England. Wales and Scotland followed the same path. The Herbert Commission (1957-60) proposed a new 'Greater London Council' to have strategic responsibility for over 600 square miles of London metropolitan sprawl. Within this new unit of government would be a number of 'boroughs'. This proposal, enacted between 1963 and 1965, unwittingly created a prototype 'city region' within the UK. The Herbert Committee's report concerned itself with issues such as appropriately-sized administrative areas and professional expertise within the new authorities. It was little concerned with the economic geography of London.

In the 1960s, a Royal Commission was set up to examine local government in England outside London. Evidence provided to this commission and a minority report by Derek Senior explicitly made the case for a system of local government boundaries<sup>1</sup>. Senior argued for 35 city-based councils where economic common interest and travel-to-work patterns were of primary importance.

<sup>1</sup> For a fuller discussion of Senior's proposals, see M Sandford, *The New Governance of the English Regions*, Palgrave Macmillan, 2005, p23



In the event, the Royal Commission majority report proposed a reform where local identities and maintaining traditional counties was a more important feature of the new councils than the logic of economic geography. However, in six big city areas, ‘metropolitan counties’ were created in 1974.

Thus, Merseyside, Greater Manchester, Tyne & Wear, West Yorkshire, South Yorkshire and the West Midlands came into being as the metropolitan counties surrounding Liverpool, Manchester, Newcastle, Leeds, Sheffield and Birmingham respectively.

Although these bodies, and the Greater London Council, were unceremoniously abolished in 1986, their ghostly form lived on when joint committees of districts to run police, fire and transport were created after their 1986 abolition. The six metropolitan counties, like the Greater London Council, were not conceived to be ‘city regions’ with economic objectives. However, during and after their lives, they established a pattern of joint working between districts which proved to be the starting point for a number of the combined authorities and city regions which exist today. The Office for National Statistics ‘Local government restructuring’ is a useful guide to the successive reorganisations and part-reorganisations of local government in England (Office for National Statistics).

The funding of the GLC and metropolitan counties was based on the traditional rating system: councils could collect property taxes from domestic and commercial ratepayers. More generally, during the period from 1974 to 1986 when the metropolitan counties and GLC existed, central government acted to reduce increases in local tax bills, either by increased grants or by capping expenditure. Just as the building blocks were being put in place for the early stages of the evolution of today’s combined authorities and city regions, local fiscal autonomy was being reduced. The Layfield Committee, which reported in 1976, proposed reforms to local taxation such as local income tax or, alternatively, to move more towards an acceptance that councils were mostly agents of central government. In the event, no action was taken by ministers to reform the system.

## THE EVOLUTION OF THE MODERN ‘CITY REGION’

Today’s new city-focused authorities are the product of a particular economic history but also of a period when urban councils had enormous economic and, for the time, fiscal powers. 19th and 20th century municipal corporations in Birmingham, Manchester, Liverpool and Leeds could raise substantial property taxes and keep extra revenues as the city grew. They often enjoyed revenues from tramways, buses and other local services. They were able to issue bonds to fund local investments. Their leaders were generally businesspeople who operated partly on business principles and partly out of enlightened self-interest.

Contemporary city regions and authorities cover a wider urban area but have far fewer financial powers. London is a special case because the mayor can set a Council Tax precept (as can combined authorities in other parts of England) and also because of the substantial fare yields available to the mayor from the city-owned Underground and buses. Elsewhere, mayors and combined authority leaders have access to local taxation only via the councils that constitute the authority. Transport services are differently run than in London with the fare yields being held by private operators.

Indeed, the individual constituent councils of the combined authorities have greater financial room to manoeuvre than city regional mayors or leaders. As a consequence, most of the resources currently available to city regions and combined authorities come from government grants for particular projects or initiatives.

The city regions with combined authorities which exist today differ from the former metropolitan counties in a number of respects. The former metropolitan counties were directly-elected with leaderships drawn from the majority political groups on the council. Today’s combined authorities in city regions have leading members drawn from constituent districts. In some (though not all) cases, combined authorities have a directly-elected mayor who is a member of the leadership.

## BRITAIN'S CENTRALISED TAX AND BUDGETING SYSTEM

Britain is very unusual in the degree to which its government and, in particular, its public finances are centralised. Table 1 below shows the taxation as a proportion of GDP available to national/federal, state/provincial and local government in a number of OECD countries. The UK is a remarkable outlier, with virtually no taxes available to sub-national government. Fiscal devolution to Wales and Scotland will increase the proportions within those nations, but the position for England will be unchanged.

Indeed, given that Council Tax is capped by the government, it would be possible to argue that, for England's sub-national government, in practice the actual proportion is zero. Capping of local taxation is not confined to the UK, but the combination of a relatively small tax base and limitations on increases in the annual rate of tax are, among larger democracies, highly unusual.

“The UK is a remarkable outlier, with virtually no taxes available to sub-national government”

**Table 1: Taxation revenue attributable to local, state/regional and national governments, selected OECD countries, 2013**

	Local government	State/Regional Government	Local and state/regional	Federal or central government	Social security	Total
Canada	2.8	12.1	14.9	12.7	2.9	30.5
France	5.8	0.0	5.8	15.1	24.0	45.0
Germany	3.0	8.0	11.0	11.5	13.9	36.5
Italy	7.1	0.0	7.1	23.6	13.1	43.9
Spain	3.2	4.5	7.7	13.8	11.1	32.7
Sweden	15.8	0.0	15.8	21.4	5.5	43.7
United Kingdom	1.6	0.0	1.6	24.9	6.2	32.9
United States	3.7	5.1	8.8	10.5	6.1	25.4
<b>OECD total</b>	<b>3.9</b>	<b>4.9</b>	<b>8.8</b>	<b>20.4</b>	<b>8.4</b>	<b>34.2</b>

(London Finance Commission, 2017)

But this is not the end of the story. The UK government sets taxes and determines expenditure allocations in a highly-centralised way. Parliament has virtually no role in either setting taxes or determining public spending priorities. The Chancellor decides the levels and structure of tax in the annual Budget, with minimal scrutiny and no effective possibilities for amendment in the Finance Bill committee. Only the threat of open rebellion by government MPs can normally change the details of a Budget, and then the process is almost always driven by the government changing details within the Finance Bill rather than by amendments being put down in committee and the Opposition winning a vote.

Expenditure decisions are even more exclusively a matter for the Executive. The Treasury holds periodic reviews and determines patterns of departmental spending for up to four years ahead. Parliament has no role in this procedure and very little in the detail of subsequent allocations from departments to services and localities. There is detailed scrutiny by the Public Accounts Committee (and other select committees) of past expenditure, but not of proposed use of money. Votes on 'Supply Estimates' are a formality only.

Against this background, city regions and combined authorities have been born into a governmental environment where they are epically distant from the kind of fiscal autonomy found in, say, Germany, Canada or even France. City regional mayors and leaders who want additional resources must get on a train to London and lobby for them.

There are consequences of this hyper-centralisation, and few of them are good. Sub-national politicians from all parts of England find themselves in a position where they can often bid for project funding without the trouble of having to raise more than a modest part of the cost. Decisions about resource use at the local level would be different if most or all the money were raised there. Moreover, all decisions on anything other than small projects are made in Whitehall. With the best will in the world, it is impossible for ministers and officials to know the detailed needs of every city and county in England.

“City regional mayors and leaders who want additional resources must get on a train to London and lobby for them”

Centralisation had led to mega-projects being favoured. High Speed 2 is a fascinating example of this phenomenon. The new rail line is being constructed from London to Birmingham, Manchester and Leeds at a cost of £50bn or more. The money was either used in this way or not at all. There was no process, for example, to determine if the cities and city regions along the line thought this was the best possible use of the money. Given that most English city regions need substantial local rail and road investment to strengthen their economic attractiveness, it was always possible that they might have opted for the development of metros and improved roads to drive up local value added rather than another mainline north-south national railway.

The centralised nature of the UK, especially England, has many, mostly unmeasured, consequences. For city regions and combined authorities, this reality means their powers to deliver are both limited and at the mercy of central government. Having said this, there are some signs that additional local revenues are not an impossible objective for sub-national government.

## CHANGES TO LOCAL REVENUE-RAISING AND FUNDING SYSTEMS

The capital, with its relatively mature model of city regional government, is perhaps the best place to see how the government can cautiously deliver reforms that increase local financial autonomy. In particular, control over transport, police and some elements of housing funding gives the Greater London Authority significantly greater financial room to manoeuvre than other city regional authorities.

London, in common with the rest of England, already has powers to introduce congestion charging and an off-street parking levy granted by the Transport Act, 2000. Ken Livingstone, as mayor, introduced a central London congestion charge in 2003 and later extended it westwards, though his successor Boris Johnson abolished the western extension. The charge generates a net sum of between £200 and £250 million per annum. Clearly, a significant extension of some form of congestion charging or road pricing could generate several times the amount generated by the central zone.

An off-street parking levy has been successfully introduced by Nottingham City Council who have used the revenue to a help pay for their expanding tram system (Nottingham City Council, 2018). Other combined authorities and city regional mayors could introduce such charges and levies if they were bold enough to do so. London has used a Business Rate Supplement to help pay for the Crossrail project. Larger nondomestic ratepayers contribute an additional 2p in the £ to help service part of the debt issued to fund the bulk of the line (Greater London Authority, 2018). Powers are available in existing legislation for other areas to use a BRS in this way, though any new levy would be subject to a referendum among business ratepayers.

The Olympic Games in 2012 were funded by an 'Olympics Levy' which was paid by households through an add-on to Council Tax (Campbell, 2003). The yield was relatively small, at about £50 million per year. Such a levy could be repeated, though only if the government allowed headroom within capping rules.

Transport for London, a mayoral agency, is experimenting with a form of road works levy. Utilities are charged for the length of time and scale of works (Transport for London, 2012). In major metropolitan areas with significant quantities of roadworks, such a levy might be another way of raising revenue while also incentivising speedy completion of projects.

The mayor of London also has access to a mayoral Community Infrastructure Levy, which is a charge on new development, per square metre, to help fund infrastructure. This source has been used to help fund transport projects. Again, the revenue from this source has been relatively modest, but it has been used to help transport projects to go ahead.

The Northern Line Underground extension to Battersea has in part been funded by development linked revenues such as 'Section 106' payments and the 'Community Infrastructure Levy' (Greater London Authority, 2011). Money is paid by developers towards the costs of infrastructure and services. Indeed, the Northern Line extension is an interesting example of how city regional leaders can lobby the Treasury for innovative financing models. The large development at Battersea/Nine Elms in Vauxhall is, in effect, being taxed to help pay for the infrastructure that allows the development to occur in the first place. Analogous so-called 'Tax Increment Finance' arrangement has been used extensively in the United States (Sell, 2014).

“London has used a Business Rate Supplement to help pay for the Crossrail project. Larger nondomestic ratepayers contribute an additional 2p in the £ to help service part of the debt issued to fund the bulk of the line”

As mentioned above, fare income from the Underground and buses is an important income source for the mayor of London, albeit one which can only be used for transport. To put the numbers in context, Transport for London's fares yield is broadly £5 billion per annum, not dissimilar to the entire Council Tax yield for the city, including that paid to the boroughs and the mayor (Transport for London, 2017, p. 11).

The transport systems in other city regions operate differently: the mayor's transport agencies in city-regions such as Birmingham/West Midlands or Greater Manchester do not set and keep fares revenue. Private companies do so, both on the rail and bus systems. Thus, while Transport for Greater Manchester will have revenue income of £320 million in 2018-19, mostly from a Council Tax precept in the 10 local districts, Transport for London has revenue income of £6,673 million, mostly from passenger fares (Greater Manchester Combined Authority, 2018; Transport for London, 2017).

It would be possible to change the legislation governing transport systems in other city regions so as to bring them into line with the London model. If this occurred, fares from rail, tram and bus systems would become a revenue source against which, for example, mayors and combined authorities could borrow to deliver new projects.

## PROPOSALS FOR MORE RADICAL REFORM

Bookshelves are filled with reviews of local government finance, but very few changes have taken place and where they have, it has often been to reduce fiscal autonomy. Only in Scotland and Wales have substantive proposals been made to devolve new taxes and also to reform how they operate. The fact that this has been possible shows that such reforms are not impossible to deliver in the UK context. However, in England ministers do not face the electoral threat of nationalism as in Scotland.

Efforts to reform local taxation and/or to devolve taxes to sub-national government have been rejected by successive governments over several decades. The subject is politically toxic, largely because of the negative public reaction to the introduction of the community charge/poll tax in 1990. Subsequently, modernisation, revaluation and reform have all proved to be beyond the ministerial bravery threshold.

London, though rarely a perfect model for reform elsewhere in the country, offers helpful evidence about how other city regions might develop. Not all of London's devolved powers and financing arrangements would necessarily be appropriate in, say Greater Manchester or the West Midlands. But the scale of the Mayor of London's powers and the resources available to the GLA do provide insights that might be helpful in the rest of the country.

Recent examinations of the issues relating to fiscal devolution to city regions and combined authorities include the reports of the London Finance Commission (LFC) and the CIPFA/Local Government Association's Independent Commission on Local Government Finance (Greater London Authority, 2017; Independent Commission on Local Government Finance, 2015). The Scottish government has also undertaken a review of aspects of local government finance. The LFC, which reported in 2014 and 2017, was concerned predominantly with London, though recommendations were made which could also be adopted by other city regions. The CIPFA/LGA initiative was a national review. Both the LFC and CIPFA/LGA reports recommended the devolution of additional tax-raising powers to cities and, in the CIPFA/LGA's case to other sub-national areas such as counties.

“Efforts to reform local taxation and/or to devolve taxes to sub-national government have been rejected by successive governments over several decades”

The LFC, probably the most radical in terms of its ambitions for fiscal devolution, suggested that all property taxes should be devolved to London, including Council Tax, business rates, stamp duty land tax and property-related capital gains tax. The 2017 LFC report also outlined how a part of income tax and VAT might be devolved as part of a wider set of reforms designed to allow more significant service devolution.

There is broad understanding that London and other city regions have less fiscal freedom and fewer devolved powers than cities and city regions in many other developed countries. But the UK government can rarely be convinced of the need for substantive devolution. The Blair government undertook a major policy of devolution to Scotland, Wales and Northern Ireland, while subsequently taxation powers have also been devolved to some extent. But England has seen only minimal steps in the same direction. There have been limited moves towards the retention of business rates, but not to the full localisation of the tax and the determination of the tax level.

Despite the fact that all other larger democracies have a greater degree of devolved power, the UK government continues to assume that only it is competent to set virtually all taxes. Fiscal devolution to city regions and combined authorities still seems a long way off.

## DEVOLUTION, GROWTH AND THE ‘UNBALANCED ECONOMY’ ISSUE

The UK has long had an economy within which some, mostly southern, regions and city regions have out-performed those in the Midlands and the North. London’s gross value added per head is 70 per cent above the UK average, while most other city regions fall below (Office for National Statistics, 2017). Successive governments have sought to reduce this difference, generally by pursuing policy measures designed to allow lagging areas to catch up with London and the South East.

George Osborne, while Chancellor of the Exchequer between 2010 and 2016, developed a ‘Northern Powerhouse’ policy which included devolution of powers to Greater Manchester and subsequently other combined authorities in city regions (Osborne, 2017). A number of reports have highlighted the need for devolution to enhance the possibility that city regional economies can be developed in such a way that they perform more productively.<sup>2</sup> While the government has announced a number of devolution deals with mayors and city regions, the powers devolved have been limited (Sandford, 2018). Even London, which has received by far the greatest political and fiscal devolution, has significantly less devolution than Wales or Scotland.

With the departure of Osborne from the Treasury, it has been less obvious where the impetus for devolution within England will now come from. A number of business rate retention ‘pilot’ schemes are being trialled in Greater London, the Liverpool City Region, Greater Manchester, the West Midlands and the West of England. Some counties are also included in these pilots. Although such initiatives sustain momentum towards greater devolution, they may not become permanent and, anyway, fall well short of the fiscal devolution now given to Wales and Scotland.

“Even London, which has received by far the greatest political and fiscal devolution, has significantly less devolution than Wales or Scotland”

Rebalancing the economy may be assisted by devolution to English city regions, but the limited nature of current reforms means that effects are likely to be modest at best.

<sup>2</sup> For a helpful analysis of the literature, see Mark Wingham, Devolution and economic growth A publication for the London Finance Commission, London Finance Commission, Greater London Authority, 2017

## FISCAL DEVOLUTION AND THE CONSTITUTION

Local government within the nations of the UK still operates in a highly-centralised way: the UK prime minister is, in effect, mayor of England. Power is centralised within the UK central government, particularly in relation to England. Within the government, power is further centralised within the core of the Cabinet and at No 10. Despite the initiatives discussed above, virtually all major decisions about raising taxation and the distribution of public expenditure are made in Westminster and Whitehall. Council Tax, the sole locally-determined revenue, is capped. In such a system, the ability of ministers and civil servants to understand the nuances and needs of city regions and counties throughout a country of 55 million people is key to effective policy formulation. Centralised policy making has so far undermined efforts to secure structural changes to the regional and city regional economy of England.

There are also constitutional implications. With power concentrated at the centre, there are fewer checks and balances on power than in a more constitutionally-separated system of government.

There is no role for representatives of sub-national government within Parliament. Parliament, in turn, has long been concerned to protect its own sovereignty, an issue given further salience by the UK's decision to leave the European Union. There is a risk that Brexit will simply transfer power from Brussels to Westminster, leaving power as remote to people who cannot directly access ministers as it was when it resided in the hands of European institutions.

“One clear implication of the ‘Leave’ vote was that people felt dissatisfied with the offer currently being made to them by successive governments”

The Brexit vote can be interpreted in many ways. But one clear implication of the ‘Leave’ vote was that people felt dissatisfied with the offer currently being made to them by successive governments. Regional imbalances, lack of access to decent services and remote government almost certainly played a part in the ‘soft revolution’ implied by the Brexit result. Leaving England as a fiscally-centralised nation where city regions and counties can only access their own taxpayers’ resources by lobbying Whitehall is unlikely to lead to the kind of sensitive and locally-focused government necessary to reduce the sense of aggravation voiced in June 2016.

## WHERE NEXT?

Theresa May’s government is engulfed by the Brexit process, and Parliament will be dominated by the subject for several years to come. Brexit is also likely to result in Whitehall departments facing a significant period of time implementing new regulatory, agricultural, industrial and migration policies. The question is: can a Whitehall machine which is so busy re-shaping the government of the country devote time to further devolution, particularly fiscal devolution, within England?

Unless the prime minister and her government decide to prioritise further reform, there must be a risk that the devolution of both powers and taxation to city regions and counties are sidelined by the needs of Brexit. The same must be true of many areas of policy in the coming years.

Devolution of decision and tax-making powers could take the strain off the embattled government machine. During a period when ministers will need all their resources to cope with exiting the EU while simultaneously negotiating dozens of trade deals, why bother with the detail of city-wide services in Manchester, London or Sheffield? National government should target its limited capacity at what only it can do. Mayors, combined authorities and counties could then get on with governing England.

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Additionally, David Phillips would like to thank Chris Belfield and George Stoye for helpful discussions on education and health funding in England. He also thanks Michael Kenny, Iain McLean and Martin Rogers and anonymous reviewers for helpful comments on earlier drafts of this chapter. Finally, he gratefully acknowledges funding from the IFS Local Government Finance and Devolution Consortium. The Consortium's core members are Capita, the Chartered Institute for Public Finance and Accountancy (CIPFA), the Economic and Social Research Council (ESRC) and PwC. Additional members include the Municipal Journal, the Society of County Treasurers and a range of councils from across England. The opinions expressed and arguments employed are those of the author, as are any errors or omissions.

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# Acknowledgements

The British Academy would like to express our sincere thanks to all of the authors and reviewers who have given up their time for this publication. Akash Paun, Professor Iain McLean, Professor Michael Kenny, Dr Mark Sandford, Professor Ed Page FBA and Professor Geneva Richardson FBA have all made valuable contributions to this work.

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ISBN: 978-0-85672-625-5  
Published July 2018

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